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In The

Supreme Court of the United States

October Term, 1989

TRINOVA CORPORATION,

Petitioner,

v.

STATE OF MICHIGAN,

Respondent.

On Writ Of Certiorari To
The Supreme Court Of Michigan

BRIEF OF CATERPILLAR INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

INTEREST OF CATERPILLAR INC. 1

SUMMARY OF ARGUMENT 2

ECONOMIC AND LEGAL ANALYSES OF THE SBT 2

ARGUMENT 4

I. THE PRACTICAL ECONOMIC EFFECT OF THE SBT 4

A. The Economic Design of the SBT 5

B. The SBT is Primarily a Tax on Labor 7

II. THE USE OF THE THREE FACTOR FORMULA IS NEITHER RATIONAL NOR CONSTITUTIONAL 10

A. The Three Factor Formula Does Not Properly Identify Michigan Value Added Activities 12

B. The Value Added Attributable to Labor Usage can be Geographically Identified .. 14

CONCLUSION 16

APPENDIX A A-1

APPENDIX B B-1

TABLE OF AUTHORITIES

Pages

CASES

American Trucking Associations, Inc. v. Scheiner, 483 U.S. 266 (1987) 4

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, *reh'g denied*, 430 U.S. 976 (1977)..... 4

Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983) 11, 14

Mobil Oil Corp. v. Department of Treasury, 422 Mich. 473, 373 N.W.2d 730, *reh'g denied*, 422 Mich. 1264 (1985) 7, 8

Norfolk & Western Railway Co. v. Missouri State Tax Commission, 390 U.S. 317, *reh'g denied*, 390 U.S. 1046 .....11, 14

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TABLE OF AUTHORITIES – Continued

Page

"Analysis of the Michigan Single Business Tax," Taxation and Economic Policy Office, Michigan Department of Treasury (January, 1985) 8

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INTEREST OF CATERPILLAR INC.

Caterpillar Inc. ("Caterpillar"), with the consent of the parties, submits this brief as *amicus curiae* in support of Trinova Corporation. Caterpillar, a Delaware corporation headquartered in Illinois, is the plaintiff in *Caterpillar Inc. v. State of Michigan, Department of Treasury*, Nos. 84-9664-CM and 87-11109-CM (consol.) (Michigan Court of Claims). Caterpillar has raised the same constitutional

objections and has requested apportionment relief substantially identical to that requested by Trinova Corporation. The decision in this case will directly affect Caterpillar's Michigan litigation.

SUMMARY OF ARGUMENT

The constitutionality of the Michigan Single Business Tax ("SBT") must be determined by analyzing its practical economic effect. In practical economic effect the SBT is a tax on labor.

The formula used to apportion a state tax must be rationally related to that type of tax. The three factor formula is not a rational means of apportioning the SBT tax base.

ECONOMIC AND LEGAL ANALYSES OF THE SBT

Mr. Robert J. Kleine was the Director and Dr. James Haughey the Assistant Director of the Office of Revenue and Tax Analysis, Michigan Department of Management and Budget, during the period in which the SBT was proposed, debated and enacted. They are acknowledged to be the primary architects of the SBT.

Mr. Kleine reviewed the design and operation of the SBT in *The Michigan Single Business Tax: A Different Approach to State Business Taxation*, Advisory Commission on Intergovernmental Relations (1978) (hereinafter cited as "ACIR"). Dr. Haughey prepared the working paper

which served as the starting point for legislative consideration of the SBT.[1] He also wrote "The Economic Logic of the Single Business Tax," 22 Wayne Law Review 1017 (1976).

Professor Oliver Oldman is the Learned Hand Professor of Law at Harvard Law School. Professor Oldman is one of the nation's leading experts on value added taxation. His qualifications include consultation with foreign governments regarding value added taxation and service on American Bar Association and United States Department of Treasury committees involving value added tax questions. In 1987, Professor Oldman testified as an expert witness regarding value added taxation and the SBT in *Caterpillar Inc. v. Department of Treasury*.[2] His testimony was directed primarily to the nature of a value added tax and the proper method of determining the Michigan value added of multistate taxpayers.

Caterpillar has taken the liberty of quoting extensively from the works of Dr. Haughey and Mr. Kleine and the testimony of Professor Oldman. They explain in clear and cogent terms the practical economic effect of the SBT and the fundamental flaw in the SBT's apportionment method.

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[1] This paper, *A Proposal for a Michigan Value Added Tax*, is reproduced as Appendix A.

[2] Professor Oldman's resume and his testimony is reproduced as Appendix B.

ARGUMENT

I. THE PRACTICAL ECONOMIC EFFECT OF THE SBT

The SBT is a novel form of state tax. Nonetheless, in determining whether it satisfies Commerce Clause concerns the approach is the same as for any other state tax: the SBT must be tested against its practical economic effect on interstate business.

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, *reh'g denied*, 430 U.S. 976 (1977) this Court held that Commerce Clause questions are to be answered by considering "not the formal language of the tax statute but rather its practical effect . . . " 430 U.S. at 279. In adopting this standard, the Court explicitly rejected a test based on the nature of the privilege being taxed, stating:

> There is no economic consequence that follows necessarily from the use of the particular words, 'privilege of doing business,' and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect.

430 U.S. at 288.

In *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266 (1987), this Court reiterated:

> In our more recent decisions we have rejected this somewhat metaphysical approach to the Commerce Clause that focused primarily on the character of the privilege rather than the practical consequences of the tax. In 1977, while we recognized that we had invalidated privilege taxes on in-state activity deemed to be part of interstate commerce, we also noted that we had 'moved toward a standard of permissibility of

> state taxation based upon its actual effect rather than its legal terminology.'

483 U.S. at 294-295. The Court further explained:

> The way in which a tax levied on participants in interstate commerce is measured and assessed bears directly on whether it implicates central commerce clause values.

483 U.S. at 282.

The "actual effect" of the SBT, the way it is "measured and assessed" on interstate business determines whether the tax is constitutional. In actual effect the SBT is primarily a tax on the use of labor. In design and in actual operation it is measured by and assessed on compensation paid.

A. The Economic Design of the SBT

In 1975, the State of Michigan responded to a fiscal crisis by adopting the SBT. As Dr. Haughey and Mr. Kleine describe the situation, Michigan's existing business taxes had two major flaws. First, the primary business taxes – the corporate income tax, franchise tax and personal property tax – fell disproportionately on profits and capital. As a result, Michigan had developed a reputation as a state with a poor climate for business investment. Second, business tax revenues were unstable and cyclical. The tax base needed to be broadened to provide more predictable revenues to fund state services. Appendix A at A-4, A-26; ACIR at 21.

A tax system based on the value added concept was proposed to solve these problems. It was anticipated that

a value added tax would improve the attractiveness of Michigan as a place for investment by equalizing the tax burden between capital and labor. As described by Dr. Haughey:

> [T]he switch to the SBT was intended to reduce the heavy burden of taxation on capital in Michigan. All of the taxes repealed were strictly on capital while the SBT taxes capital and labor costs equally. The expected result, after an adjustment process, is the stimulation of job-creating capital investments in Michigan and expansion of demand for the goods and services of local market industries.

22 Wayne L. Rev. at 1021-22.

The goal of revenue stability would also be accomplished. Again quoting Dr. Haughey:

> [T]he switch to the SBT was intended to increase the stability of state business tax revenues over the business cycle. This was to be accomplished by abandoning profits as the principal business tax base and adopting value added, the sum of labor and capital costs, which is inherently more stable than the narrow margin between sales and expenses.

22 Wayne L. Rev. at 1021 (footnote omitted). Kleine concurs. He states:

> The instability of the business tax structure, particularly the corporate income tax, had precipitated two budget crises in Michigan, in FY 1970-71 and 1974-75. Therefore the proponents of the VAT believed the corporate income tax to be an inappropriate tax for a state with such a volatile economy. The VAT is much more stable than the corporate income tax, largely because

> 75% of the base consists of compensation, which is not subject to wide swings from year to year.

ACIR at 21.

A final benefit of the SBT was a closer matching of tax burdens with the benefits each business received from governmental services. Because the amount of Michigan governmental services consumed, e.g., roads, utilities, fire and police protection, education and social welfare services, is related to the economic size of the business (amount of labor and capital used in the form of the company's work force and its production and distribution facilities in Michigan) and because the value added tax base also reflects the taxpayer's economic size in Michigan, a value added tax would impose tax burdens more nearly proportional to the governmental services used by each business. See, e.g., ACIR at 23. The base broadening thus accomplished three goals: reducing the burden on capital, improving revenue stability and making the tax more proportional to benefits received.

B. The SBT is Primarily a Tax on Labor

The components of a value added tax base are well recognized. The Michigan Supreme Court described these components in *Mobil Oil Corp. v. Department of Treasury*, 422 Mich. 473, 373 N.W.2d 730, *reh'g denied*, 422 Mich. 1264 (1985):

> The value of the inputs used is measured by the cost to the producer of obtaining the use of those inputs. The value of the worker's labor is the wages the laborer is paid to produce the good. The value of the raw materials, intermediate goods, and capital is what the producer must

> pay in order to obtain the use of these things. And the profit is what keeps the producer-entrepreneur in business, which is measured by the difference between the cost of production and the receipts from sales.

422 Mich. at 493-94, 373 N.W.2d at 740.

Professor Oldman elaborated on the notion that the SBT tax base consists of discrete identifiable components:

> And in the report of the Special Committee on VAT, which had a number of reports, 1971 to 1977, I quote from the definition that was in there, "the tax base on which a VAT is levied is essentially equivalent to the sum of a firm's profits and payments for its factors of production not subject to VAT – normally interest, compensation, depreciation and rentals paid." That is, the input on which somebody else has paid VAT is not part of the taxpaying firm's VAT. And its profits and payments include normally, and I quote again, "interest, compensation, depreciation and rentals paid."
>
> So these definitions of value added are widely accepted and understood, both by the policymakers, the theoreticians, and the legislators, and the courts, which have said something about it.

Appendix B at B-21 – B-22.

By far the largest of the value added components of the SBT is labor.[3] Sidney Goodman, former Michigan

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[3] Labor makes up approximately 77 percent of the SBT base. Profit makes up less than 6 percent and the remainder consists of other items, primarily depreciation. "Analysis of the Michigan Single Business Tax," Taxation and Economic Policy

(Continued on following page)

Commissioner of Revenue, acknowledged the importance of the labor component in his paper delivered at the NTA-TIA Annual Conference on November 16, 1976, "Administrative Aspects of the Michigan Single Business Tax (VAT)," which is reproduced in Kleine's monograph:

> From studies made we have found that compensation has in many instances exceeded 70% of the tax base. The only relief granted in the law is a circuit breaker provision limiting compensation to 65% of the tax base so that high-labor-intensive firms would have some relief. The issue at the present time is whether this limit should be lowered in order to prevent the single business tax from being a tax on labor.

ACIR at 55. Mr. Kleine echoes these observations:

> As more than three-quarters of value added reflects labor input, the VAT looks to be largely a tax on labor.

ACIR at 23. Professor Oldman further confirmed this point in the following colloquy with Department of Treasury counsel:

> A. A tax on value added is a tax on payroll to a very important extent.
>
> Q. This is where we disagree. A tax on value added is a tax upon the incremental mark-up at any stage of production.
>
> A. And that's largely constituted by payroll. The markup is, in your example, where there is an 80 percent payroll, 80 percent of

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(Continued from previous page)

Office, Michigan Department of Treasury, Table 4, p.27. (January, 1985)

the markup is due to payroll, to compensation.

Q. That is when you look at the – that is purely a sourcing theory?

A. It's a fact, it's a fact. You don't need a label legal or otherwise on it. 80 percent of the difference between sales and taxable input is compensation. And that's what the books show. And that is the heart of value added.

Appendix B at B-64 – B-65. These comments by Goodman, Kleine and Professor Oldman explain why the title of Dr. Haughey's draft statute was "PROFITS AND PAYROLL TAX ACT OF 1975." Appendix A at A-8.

II. THE USE OF THE THREE FACTOR FORMULA IS NEITHER RATIONAL NOR CONSTITUTIONAL

Michigan's decision to use the three factor formula to apportion the tax base of interstate businesses was not founded on logic or analysis. The drafters believed that use of the formula was compelled by Michigan's membership in the Multistate Tax Compact. As Mr. Haughey put it:

> A final practical concern is the treatment of multistate taxpayers. The former BAT and the current corporation income and corporation franchise tax employ the three factor Massachusetts formula to apportion income between states. Michigan's membership in the Multistate Tax Compact will undoubtedly require the same formula for the VAT. The current proposal reluctantly assumes the use of the three factor formula.

Appendix A at A-8. Whether required by the Compact or not, the three factor formula is not constitutional when used in the SBT because it is not rationally related to the determination of value added in Michigan.

In *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, *reh'g denied*, 390 U.S. 1046 (1968), the taxpayer challenged the formula used by Missouri to determine its Missouri property. The Court stated:

> Any formula used must bear a rational relationship, both on its face and in its application, to *property* values connected with the taxing State.

390 U.S. at 325. [Emphasis added]

In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), the taxpayer challenged the formula used by California to determine its California income. The Court again stated:

> The second and more difficult requirement is what might be called external consistency – the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how *income* is generated.

463 U.S. at 169. [Emphasis added]

Here the taxpayer has challenged the formula used by Michigan to determine its Michigan value added. The formula used by Michigan must be rationally related to and reflect a reasonable sense of how Michigan *value added* – primarily labor usage – is generated. The three factor formula fails this test.

A. The Three Factor Formula Does Not Properly Identify Michigan Value Added Activities

Professor Oldman and Mr. Kleine agree that the three factor formula, and particularly the sales factor, is not rationally related to the activities which generate Michigan value added. As Mr. Kleine states:

> The standard three factor formula [payroll, property, sales] was used to apportion the tax base of multistate taxpayers. Value added theory would dictate that the tax be calculated on an "origin" basis and implies use of the two-factor formula – property and payroll.

ACIR at 7. He goes on to point out that:

> A tax on value added is levied at the source of production, at the origin, whether that production is intended for sale in another state or country.

ACIR at 14, note 5.

In response to a question concerning the relevance of sales to a value added tax, Professor Oldman answered:

> A. Well, sales represent, you might say, the consummation of the entire value-adding process. The sales price of goods represents the total value added by the firms that sell those goods, plus the value added by all the firms which supplied input to the taxable firm that we are now taxing. So the sales of the firm include not only its value added, but also the value added by the firm's suppliers. If what you are trying to identify is the location of the firm's value added, then sales – the location of sales would basically be irrelevant. It's the components of value added that you are trying to locate, not the

> sales. The sales are the sum total, the result of the value adding process. But the sales don't tell you where the value was added. Therefore, it's an extraneous factor to determining the geographical location of the value added. The components are the profit and the wages. They are the primary components. The wages can be located easily by knowing where the work was done. So one doesn't need a formula at all for that.

Appendix B at B-29 – B-30. Professor Oldman goes on:

> Q. As I understand your testimony, then, it would be your opinion that the sales factor is not appropriate for utilization in the value-added tax?
>
> A. Right, it is my opinion that the sales factor, that sales themselves, represent the ultimate goal of the value adding process, and that to use that to geographically locate where the value was added provides a misleading geographic picture of where the value-adding process takes place.
>
> When a jurisdiction purports only to tax value added within its jurisdiction, that originates within its state or country, and it has taxpayers who operate in more than one jurisdiction, it has to face up to the problem of geographical division of the tax base. The way to do that is not by looking at where the sales take place, you use sales to apportion gross receipts taxes, and you use sales in conventional corporate income tax as a handy representation of the demand factor in producing profit. But to use sales in the value-added tax is almost a contradiction in terms, because it's not really related to the value added tax process.

Appendix B at B-33 – B-34.

Use of the three factor formula in the SBT does not satisfy the "external consistency" test articulated in *Container* and *Norfolk & Western*. It is not rationally related to the value added process and in Professor Oldman's phrase "provides a misleading geographic picture of where the value-adding process takes place".[4] The Commerce Clause does not permit use of such a formula.

B. The Valued Added Attributable To Labor Usage Can Be Geographically Identified

In his testimony, Professor Oldman repeatedly made a simple point – no formula is required to determine Michigan's share of an interstate company's labor usage. As Professor Oldman put it:

> In the world of value-added tax, you know where most of the value added is, in fact, added because you know where the workers are. So you don't have to use the formula. You take the wages paid for services performed at a location and say that's the value added by compensation in that area.

[4] There will undoubtedly be cases where the three factor formula produces a reasonable approximation of the taxpayer's Michigan value added. This would happen, for example, when the percentage of the taxpayer's Michigan property, payroll and sales are roughly equivalent. Even in that case, however, the formula approximates reality by accident, not design. Appendix B at B-63. It is equally certain that there will be cases where the formula understates Michigan value added. This will occur when the formula is used by Michigan based companies which ship most of their production to consumers in other states. Appendix B at B-75.

Appendix B at B-29. Professor Oldman made the same point when discussing Michigan court decisions which permitted taxpayers to determine their compensation on a geographical basis. He stated:

> If the Department of the Treasury applies the statute in a way in which an artificial result is achieved as it was proposed in the *J&L*, then the courts come in and bring reality into the picture, and state, quite correctly, that you can't locate where the payroll element or components of value added are by looking at where the sales took place, or where the sales ended up. You locate payroll by looking at where the people worked.

Appendix B at B-32.

In the end, this is all that Trinova has asked the Michigan courts to do – bring reality into the picture and locate Trinova's payroll by looking at where its people work. Trinova has established its total payroll in Michigan. This is all the labor cost Michigan may tax.

CONCLUSION

The SBT should be recognized for what it is – a tax on labor. The three factor formula is not designed to and does not in practice fairly apportion the tax base of Trinova and similar companies. The decision of the Michigan Supreme Court should be reversed with instructions to grant Trinova the right to pay tax on its actual Michigan value added.

Respectfully submitted,

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APPENDIX A

A PROPOSAL FOR A MICHIGAN VALUE ADDED TAX

James Haughey
Department of Management
and Budget
State of Michigan
Lansing, Michigan
December 27, 1974

PREFACE

This paper contains a rough outline of a Value Added Tax (VAT) now being considered by the State of Michigan. No decision has yet been made to seek the adoption of VAT and other tax alternatives, in lieu of a VAT, are being considered.

The paper briefly states the reasons for considering a VAT, outlines tentative draft legislation and discusses the principal theoretical and practical decisions that need to be made. As the paper was prepared under a strict time constraint it raises many questions that are left unanswered and may ignore some important considerations.

The purpose of the paper is to elicit comments and criticism from interested and knowledgeable people. Comments are welcome on the theoretical design of the tax, the language of the enabling legislation, practical problems in administration and compliance, the economic effects of a shift to a VAT, the financial impact on various industries, unique problems in certain industries and methods for forecasting the receipts from a VAT.

Introduction

The State of Michigan is considering the adoption of a Value Added Tax (VAT). Present, tentative plans are for enabling legislation to be introduced in the spring of 1975, with the effective date set for January 1, 1976.

From 1953 to 1967 Michigan had a Business Activities Tax (BAT) similar in many ways to a VAT. The BAT was originally enacted in lieu of a corporation income tax and was ultimately replaced by that tax. The BAT was essentially a gross receipts tax that permitted more exemptions and deductions than would be allowed by a pure VAT.

Two years ago a VAT was proposed as part of the financing mechanism for a constitutional amendment requiring state financing of local schools. The amendment was defeated and the VAT dropped from public view. As the defeated constitutional amendment was quite controversial and complex the public reaction to the VAT proposal was not at all clear. However, it was generally supported by business groups and opposed by labor groups.

The purpose of this paper is to present an outline of the nature and use of the VAT proposed in Michigan. This paper is intended to serve as a point of departure. It raises what are thought to be all of the relevant questions that must be answered concerning the theoritical design of a VAT, the practical application of the concept and the economic impact of a shift from other taxes to a VAT. Many of these questions are answered here. The answers reflect current thinking and do not reflect final decisions. The VAT could be a replacement for the corporation income tax, the corporation franchise tax, the business

portion of the intangibles tax, the financial institutions income tax, the personal property tax on inventory, and possibly the insurance premiums tax. A small amount of additional revenue would also be raised by the VAT.

Overview of Proposal

The VAT being proposed here can be described as a consumption type VAT with the tax base determined by the addition of factor payments made by the taxpayer. The tax is to be collected like an income tax with quarterly estimates and an annual settlement.

Three types of VAT bases are possible:

1) The gross product base with no deduction for either capital consumption or capital acquisition.

2) The "income" variant with deductions permitted for capital consumption.

3) The "consumption" variant with deductions permitted for capital acquisition.

The gross product base is rejected because some type of capital deduction is too well accepted to be challenged and because capital expansion ought not to be penalized.

Allowing depreciation and depletion was rejected because much of the uncontrollable, unpredictable and arbitrary features of the corporation income tax are in the depreciation/depletion section of the law. One of reasons for considering a shift to the VAT from the income tax is to make business taxes more stable, more predictable, and more controllable by the state. The profits tax base is, to a large extent, beyond the control of the state. Congress and the IRS can and do alter the state profits tax

base for their own purposes and without adequate warning or explanation. Changes in depreciation/depression [sic] rules are announced frequently. A fuller discussion of the superiority of the VAT over those taxes it would replace follows later.

The deduction of capital acquisition costs was selected on its merits and not because of the faults of the other two options. In the past few years numerous efforts have been made in Michigan, some successfully, to enact "tax incentives" for business expansion. The tax laws now contain a variety of such incentives, generally discriminatory and inefficient. A capital acquisition deduction in the VAT, together with a necessarily higher tax rate, could serve as a once and for all super tax incentive in lieu of all existing and proposed incentives. It is still unclear whether the capital acquisitions deduction in lieu of depreciation should be allowed for all investment anywhere or whether after apportionment, the taxpayer should add his Michigan depreciation and subtract his Michigan capital acquisitions. Depreciation or investments capitalized by December 31, 1975 would not be part of the VAT base in either case.

The current proposal also includes the addition of factor payments as the method of calculation of of the tax. This contrasts with the sales tax type credit method in use in most, if not all, existing VAT taxes. Under this method the tax base is total sales with a credit allowed for the tax paid by suppliers and shown on invoices for the purchase of goods and services. No criticism is made of this method but it would not be workable in Michigan where most

of the suppliers of goods and services to Michigan taxpayers are not themselves located in Michigan. Compliance and audit problems would be insurmountable.

Although the European credit method must be rejected it could still be possible to calculate the tax by subtracting from sales the purchases made from other taxable firms. This was the approach of the Michigan BAT. However, several of the state's major taxpayers report that they used the addition method for the BAT tax anyway because it was easier and conformed more closely with the accounts and concepts required for federal income tax purposes.

Several, more practical, decisions also have had to be made on the design of the VAT. These are concerned with the coverage of the tax. The proposal would apply the tax to all economic units in the economy, except government enterprises and non-business, non-profit organizations. There would be no exemptions for certain types, legal forms or size of business. For administrative reasons paper boys, baby sitters, etc. would not be taxed nor would the casual earnings of wage earners. A blanket exemption of all taxpayers with a value added of less than $1,000 is part of the proposal.

Thus, the self-employed would be liable for the VAT but would be permitted to exempt the "undistributed" profit component of their income from the personal income tax. Exactly how this would be done is unclear, but it does seem to be necessary to keep the tax system neutral with respect to legal forms of organization.

Because it is impractical to tax the implicit rent of owner occupied houses, rent paid for residential housing

would be exempt from the tax to assure equal treatment of homeowners and renters.

The financial and insurance industries also present special problems because of their unique accounting and federal tax treatment. Interest paid is part of the VAT base, representing the value added attributable to capital. But in the financial sector interest is also treated as sales receipts. Similar problems exist with interest received by banks. In addition, there is a considerable amount of implicit interest paid (on non-interest bearing deposits) in the form of bank services. Bad debts and other reserves are calculated differently by banks than by other corporations. Finally, there are a variety of financial and quasi-financial firms, some of which have subsidiaries and some of which are subsidiaries of non-financial firms. The use of a VAT in the financial sector is not yet well understood. The current proposal defines the VAT base in the financial sector as rent and labor payments plus residual profits as now defined in the tax laws.

Special treatment of insurance carriers is also needed. The interest problem discussed above is present here as well as problems with loss reserves and interest or dividends paid or credited to policyholders or members. The current proposal plans to handle the interest problem the same as for financial institutions, adjust loss reserves to realistic experience levels and include dividends and interest paid to members or policyholders as part of the VAT base.

Unique accounting practices also may require special provisions to apply the VAT concept uniformly to farming, coop firms, fiduciaries, and regulated industries.

A final practical concern is the treatment of multi-state taxpayers. The former BAT and the current corporation income and corporation franchise tax employ the three-factor Massachesetts formula to apportion income between states. Michigan's membership in the Multi-State Tax Compact will undoubtedly require the same formula for the VAT. The current proposal reluctantly assumes the use of the three-factor formula. Corporate taxpayers would be permitted to file a consolidated return if they do so with the federal income tax. World-wide consolidation would not be permitted (it is currently required).

Draft Legislation

The VAT draft prepared in October, 1972 is reproduced here with only a few changes. The administrative sections have not yet been prepared but would parallel the law for the corporation income tax. Additional legislation to repeal and modify existing taxes would also be necessary.

PROFITS AND PAYROLL TAX ACT OF 1975
December 27, 1974

CHAPTER I

Sec. 1. This act shall be known and may be cited as the "profits and payroll tax act of 1975."

Sec. 2 (1) For the purposes of this act, the words, terms and phrases set forth in this chapter and their derivations have the meaning given therein. When not inconsistent with the context, words used in the present tense include the future, words in the plural number include the singular number, and in the singular number

include the plural. "Shall" is always mandatory and "may" is always discretionary.

(2) Any term used in this act and not herein defined shall have the same meaning as when used in comparable context in the laws of the United States relating to federal income taxes unless a different meaning is clearly required. Any reference in this act to the internal revenue code shall include other provisions of the laws of the United States relating to federal income taxes.

(3) For the convenience of both taxpayers and the Commissioner, the tax imposed by this act has been designed to utilize much of the information required of taxpayers in filing federal income tax returns and to utilize much of Internal Revenue Code and related provisions of the Laws of the United States. However, it is the intent of this act to tax all value-added, unless expressly exempted by chapter 2, originating in or apportioned to Michigan. The term "value-added" shall be interpreted in the sense that that term is used in relation to the National Income Accounts of the United States. The references to the Internal Revenue Code shall not be construed to exempt from taxation any value-added not expressly exempted by chapter 2.

(4) The term "rent" includes lease payments or any other payments for the use without ownership of any property.

Sec. 4 (1) "Business activity" means sales or rentals of property, whether real, personal or mixed, or the performance of services, or any combination of sales or rentals of property and performance of services made or engaged in, or caused to be made or engaged in, within this

state, whether in intrastate, interstate or foreign commerce, with the object of gain, benefit or advantage, either direct or indirect, to the taxpayer or to others, but shall not include the services rendered by an employee to his employer or a casual transaction.

(2) "Business income" means federal taxable income; except that for persons other than corporations it means that part of federal taxable income derived from business activity.

Sec. 6. (1). "Casual transaction" means a transaction made or engaged in other than in the ordinary course of repeated and successive transactions of a like character, except that any transaction made or engaged in by any person which is incidental to that person's business activities, shall be considered to be a business activity within the meaning of this act.

(2) "Commissioner" means the commissioner of the department.

(3) "Compensation", means all remuneration for labor services paid in cash or other medium to, on behalf of, or for the benefit of employees, officers, directors, partners or any individual or entity not itself a taxable or specifically exempt person or an employee, officer, director, or partner of a taxable or specifically exempt person. Compensation includes, but is not limited to wages, salaries, fees, bonuses, omissions, social and self insurance of any kind, payments to individuals not currently working, payments to dependents and heirs of individuals because of current or former labor services rendered by them, payments to any pension, retirement, or profit sharing plan, the economic gain inherent in any stock

options granted and exercised and the remuneration inherent in any merchandise or service discounts and payments for insurance for which employees are the beneficiaries.

Compensation includes remuneration paid in any medium other than cash only to the extent that such payment is not in the form of goods and services purchased from a taxable or specifically exempt person.

Sec. 10. "Department" means the revenue division of the department of treasury.

Sec. 12. (1) "Employee" means an employee as defined in section 3401(c) of the internal revenue code in effect on December 31, 1975. Any person from whom an employer is required to withhold for federal income tax purposes shall prima facie be deemed an employee.

(2) "Employer" means an employer as defined in section 3401(d) of the internal revenue code in effect on December 31, 1975. Any person required to withhold for federal income tax purposes shall prima facie be deemed an employer.

Sec. 14. (1) "Federal taxable income" means taxable income as defined in Section 63 of the Internal Revenue Code.

Sec. 16. "Internal Revenue Code" means the United State Internal Revenue Code in effect on December 31 , 1975.

Sec. 20. (1) "Paid" means and is interchangeable with "accrued" in the case of a taxpayer on the accrual basis of accounting.

(2) "Person" includes any individual, firm, bank, financial institution, limited partnership, copartnership, partnership, joint venture, association, corporation, receiver, estate, trust, or any other group or combination acting as a unit, and the plural as well as the singular number.

Sec. 22. "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country, or political subdivision thereof.

Sec. 24. (1) "Tax" includes interest and penalties unless the intention to give it a more limited meaning is disclosed by the context.

(2) "Tax year" or "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the tax base is computed under this act. In the case of a return made for a fractional part of a year, the term shall mean the period for which such return is made. Except for the first return required by this act, any taxpayer's tax year shall be for the same period as is covered by his federal income tax return.

(3) "Taxpayer" means any person liable for any tax, interest or penalty under this act.

Sec. 26. "Unrelated business activity" means any business the conduct of which is not substantially related (aside from the need of the corporation or association for income or funds or the use it makes of the profits derived) to the exercise or performance by the corporation

or association of its religious, charitable, scientific, literary, educational or other purpose or function which constitutes the basis for its exemption under section 60.

Sec. 28. "Tax base" means business income, even if zero or negative, subject to the following adjustments to the extent related to business activity:

(a) Add gross interest income and dividends derived from obligations or securities of states other than Michigan, in the same amount that has been excluded from Federal Taxable Income, less related expenses not deducted in computing federal taxable income because of section 65 of the Internal Revenue Code.

(b) Add all taxes paid everywhere on or measured by net income or value-added to the extent the taxes have been deducted in calculating Federal Taxable Income.

(c) Add losses on the sale or exchange of obligations of the United States government, the income of which this state is prohibited from taxing, to the extent the loss has been deducted in calculating federal taxable income.

(d) Deduct to the extent included in Federal Taxable Income, income derived from obligations and income from the sale or exchange of obligations of the United State government, which this state is prohibited from taxing, less any interest on indebtedness incurred to carry the obligations and less any expenses incurred in the production of such income, to the extent that the interest and expenses, including amortizable bond premiums, were deducted in arriving at Federal Taxable Income.

(e) Add, to the extent deducted or excluded in arriving at federal taxable income:

(1) Any net operating loss and capital loss carryforward.

(2) Any capital gains related to business activity except gains derived from the sale or dispossession [sic] of tangible assets.

(3) Any deduction for the using up of tangible capital assets, such as depreciation, depletion, amortization, immediate or accelerated write-off of capital assets and unused investment credit deduction.

(4) Any dividends paid.

(5) Any loss due to the expropriation of property.

(6) Any deduction or exclusion due to the classification of a taxpayer as a Domestic International Sales Corporation, Western Hemisphere Trade Corporation, China Trade Act Corporation or any like special classification the purpose of which is to reduce or postpone the Federal Income Tax Liability.

(7) All compensation paid everywhere.

(8) Royalties, interest, all rents, less any receipts from subletting, and any other form of capital or property payments paid which constitute income to the payee except the distribution of residual equity profits.

(9) Any other deduction or exclusion which, if not added to the tax base, would exempt from taxation some value-added not expressly exempted in chapter two.

(10) The proceeds from the sale of tangible capital assets.

(f) Deduct, to the extent included in federal taxable income:

(1) Dividends received or deemed received.

(2) Rent received.

(3) Royalties, interest and any other form of capital or property income received except rent and the distribution of residual equity profits.

(4) Any capital loss not deducted in arriving at federal taxable income.

(g) Deduct the acquisition cost of tangible assets eligible for depreciation, amortization or depletion for federal income tax purposes.

(h) Add the value of all inventories at the end of the taxable year and subtract the value of all inventories at the beginning of the taxable year.

Sec. 29. The tax base of non-profit persons not required to pay federal income taxes shall be the sum of the net additions to, less the deductions specified in Sec. 28.

Sec. 30. The tax base of any person, 90 percent of whose assets are intangible personal property or 90 percent of whose income is dividends, interest or other charges resulting from the use of money and credit, shall not be less than the sum of federal taxable income and the adjusted [sic] provided in Section 28, with the exception of paragraph e, subparagraph 8 and paragraph f, subparagraphs 1 and 3.

CHAPTER 2

Sec. 50. There is hereby levied and imposed a specific tax of ___ upon that portion of the tax base of every person which is allocated or apportioned to this state in accordance with the provisions of Chapter 3 of this act.

Sec. 60. There shall be exempt from the tax imposed by this act:

(1) The entire tax base of any person whose tax base before allocation is $1,000 or less

(2) The United States, this state, other states and the agencies, political subdivisions and enterprises of each

(3) Schools, hospitals, religious and ecclesiastical associations and corporations, homes for the care and maintenance of children or aged persons, and other health, welfare, educational, charitable or benevolent institutions and agencies, operated by an entity of government, a regularly organized corporation incorporated under the laws of the state, when the income or benefit does not inure, in whole or part, to any individuals or private shareholders, directly or indirectly, and when the activities of the entity or agency are carried on exclusively for the benefit of the public at large and are not limited to the advantage, interest and benefits of its members of any restricted group.

This exemption shall not apply to the tax base derived from any unrelated business activity or to any agency or entity currently taxable under the Michigan general property tax laws or substantially organized for the purpose of providing goods or services to its members at a reduced price.

(4) Any value added from the rental of a residential homestead.

CHAPTER 3

Sec. 102. In the case of a taxpayer whose business activities are confined to this state, the entire tax base of such taxpayer shall be allocated to this state, except as otherwise expressly provided in this act.

Sec. 103. Any taxpayer whose business activities are taxable both within and without this state, shall allocate and apportion his tax base as provided in this chapter.

Sec. 105. For purposes of allocation and apportionment of the tax base from business activities under this act, a taxpayer is taxable in another state if, (a) in that state he is subject to profits and payroll tax, a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a profits and payroll tax regardless of whether, in fact, the state does or does not.

Sec. 115. All of the tax base, other than the tax base derived from transportation services or specifically allocated, shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.

Sec. 116. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of

which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

Sec. 117. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at 8 times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

Sec. 118. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the commissioner may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

Sec. 119. The payroll factor is a fraction, the numerator of which is the total compensation paid in this state during the tax period by the taxpayer and the denominator of which is the total compensation paid everywhere during the tax period by the taxpayer. For the purposes of this chapter only, "compensation" means wages as defined in section 3401 of the Internal Revenue Code.

Sec. 120. Compensation is paid in this state if:

(a) The individual's service is performed entirely within the state; or

(b) The individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) Some of the service is performed in the state and (i) the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is in the state, or (ii) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

Sec. 121. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

Sec. 122. Sales of tangible personal property are in this state if:

(a) The property is delivered or shipped to a purchaser, other than the United State government, within this state regardless of the f.o.b. point or other conditions of the sales; or

(b) The property is shipped from an office, store, warehouse, factory or other place of storage in this state and (i) the purchaser is the United States government or (ii) the taxpayer is not taxable in the state of the purchaser.

Sec. 123. Sales, other than sales of tangible personal property, are in this state if:

(a) The business activity is performed in this state; or

(b) The business activity is performed both in and outside this state and based on costs of performance, a

greater proportion of the business activity is performed in this state than is performed outside this state.

Sec. 131. The tax base of a taxpayer whose business activities consist of transportation services rendered partly within and partly without this state shall be determined under the provisions of sections 132 to 134.

Sec. 132. In the case of such tax base other than that derived from the transportation of oil or gas by pipeline, that portion of the tax base of the taxpayer derived from transportation services wherever performed that the revenue miles of the taxpayer in Michigan bear to the revenue miles of the taxpayer everywhere. A revenue mile means the transportation for a consideration of 1 net ton in weight or 1 passenger the distance of 1 mile. The tax base attributable to Michigan sources in the case of a taxpayer engaged in the transportation both of property and of individuals shall be that portion of the entire tax base of the taxpayer which is equal to the average of his passenger miles and ton mile fractions, separately computed and individually weighted by the ratio of gross receipts from passenger transportation to total gross receipts from all transportation, and by the ratio of gross receipts from freight transportation to total gross receipts from all transportation, respectively. If it is shown to the satisfaction of the commissioner that the foregoing information is not available or cannot be obtained without unreasonable expense to the taxpayer, the commissioner may use such other data which may be available and which in the opinion of the commissioner will result in an equitable allocation of such receipts to this state.

Sec. 133. In the case of the tax base derived from the transportation of oil by pipeline, the tax base attributable to Michigan shall be that portion of the tax base of the taxpayer derived from the pipeline transportation of oil everywhere that the barrel miles transported in Michigan bear to the barrel miles transported by the taxpayer everywhere.

Sec. 134. In the case of the tax base derived from the transportation of gas by pipeline, the tax base attributable to Michigan shall be that portion of the tax base of the taxpayer derived from the pipeline transportation of gas everywhere that the thousand cubic feet miles transported in Michigan bear to the thousand cubic feet miles transported by the taxpayer everywhere.

Sec. 145. (1) If the taxpayer's only business activities within this state consist of sales and do not include owning or renting real estate or tangible personal property and whose dollar volume of gross sales made during the tax year within this state is not in excess of $100,000.00 the taxpayer may elect for that year to report and pay a tax on the tax base arrived at by multiplying total sales in this state for the taxable year by the ratio of the tax base, for the tax imposed by this act, to total sales as reported on the taxpayer's federal income tax return for the same taxable year.

(2) The election is not available for any taxable year for which a consolidated return is required.

Sec. 147. (1) If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in

respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

(2) An alternative method will be effective only with approval by the commissioner.

Characteristics of the VAT and Taxes to be Replaced

Apart from the level of revenues, taxes have other effects on the economy. Any change in tax laws should be made only after evaluating the change against some criteria of "good tax policy." The following points should be considered.

(1) The neutrality of the tax on market decisions.

(2) The alteration of the distribution of income resulting from the tax.

(3) The effect of the tax on price levels and overall resource utilization.

(4) The ease of tax administration and compliance.

(5) Windfall gain or losses from the tax change.

Since Michigan has the most cyclical economy of any state but is constitutionally prohibited from incurring an

operating deficit, two considerations important to the tax collector must be added.

(6) The income elasticity of the tax.

(7) The stability or predictability of tax receipts.

The corporation franchise tax and the income taxes are clearly non-neutral with respect to legal form of organization and factor proportions. The business portion of the intangibles tax, a tax on accounts receivable, is similarly non-neutral. The same must be said for the insurance premium tax which is an excise tax.

Only the VAT is neutral. This characteristic is elusive but important. Consider the amount of resources wasted annually by altering legal forms of organization for tax purposes and such misdirected use of resources as the report of a company that profited from spending $100,000 to recover, as expected, $50,000 worth of oil.

The impact of business taxes on income distribution is a matter of much dispute. However, there is little reason to believe that the impact of a VAT would be much different from other business taxes. Nonetheless it will be necessary to counter the recurrent argument that the corporate income tax only reduces profits while the VAT is a regressive sales tax.

The State of Michigan, or any state, has little effect on and should not be concerned about macroeconomic stablization matters. The single exception is the effect of the choice of taxes on price levels within the state, which depends on the incedence of business taxes. A priori, the choice of taxes should have little effect. Although the more efficient VAT should, over a period, reduce waste

and hence prices, the switch from one tax to another may cause a one time price level increase. (See below)

The four existing business taxes, as well as the VAT, can be calculated from the financial records business firms are required to keep for preparation of their federal income tax returns. In this sense, none of them impose unusual or difficult compliance problems. However, compliance costs are high for the corporate income and franchise taxes due to legal ambiguities in the definition of the tax base and the availability of optional accounting methods.

A single replacement tax for four existing taxes would obviously simplify both administration and compliance. In addition, hopefully, the VAT base would be more precisely defined, after initial legal tests.

Any significant tax change produces windfall gains and losses. Upsetting the existing economic balance causes the losers to react in a manner designed to protect their position. A single once and for all increase in price levels should be anticipated as those whose taxes rise try, to the extent their markets permit, to maintain their profits.

Despite the obvious fact that windfall effects are negligible in the long run they must be considered as the political process has a high discount rate. A thorough study of the tax liability of various industries before and after the adoption of a VAT has not yet been done. However, it does appear that those industries that would receive windfall gains would be:

(1) Industries earning a higher than average profit.

(2) Capital intensive industries with a relatively small payroll and high corporate franchise tax.

(3) Industries with good cash management and hence relatively little taxable accounts receivable.

(4) Industries with few special tax provisions now paying income taxes at close to the nominal tax rate.

(5) Expanding industries with large capital acquisition deductions.

Unincorporated industries would not benefit from the repeal of the franchise tax but would benefit from the exemption of the "owner's profit" from the personal income tax. In general, corporate firms would benefit more than unincorporated firms from the adoption of VAT.

By definition, the income elasticity of a VAT is approximately 1.0. Permitting a capital acquisitions deduction will alter the year to year elasticity. An elasticity of less than 1.0 would be anticipated in the final stages of an expansion period for example. The tax on accounts receivable has had an estimated elasticity of slightly less than 1.0, presumably due to improving cash management. The insurance premium tax has an elasticity of about 1.0. The income elasticity of the corporate income and franchise taxes are difficult to calculate due to changing tax bases, accounting practices and the timing of payments and refunds. Both appear to have an elasticity of between 0.6 and 0.7.

The receipts from the taxes on accounts receivable and insurance premiums are reasonably stable and not difficult to predict. The receipts from the franchise tax are also stable, although the tax base is continually being

redefined by the courts and by changes in accounting practices.

The corporate income tax is an unstable tax. This fact is one of the prime reasons for considering the adoption of a VAT. Tax receipts are far more unstable than the underlying profits due to unexpected changes in the tax base, by Congress, the IRS, and the accounting profession and the payment options available to taxpayers. The table below shows the instability and the resultant difficulty in predicting revenues.

	Prediction			
Fiscal Year	6 Months Before F.Y.	6 Months Into F.Y.	Receipts	Actual Adj. to Current Rate
1973-74	360	410	385	385
1972-73	315	350	369	369
1971-72	240	265	270	301
1970-71	215	151	149	231
1969-70	270	239	224	262
1968-69	230	274	247	293

In the current fiscal year, the estimate is made difficult by the pending federal tax reform legislation, the growing shift to LIFO inventory accounting, delays in payments to conserve corporate cash, and a switch to consolidated returns. The confidence interval of the estimate is considerably larger than the estimated surplus in the state budget. This creates considerable budgetary problems, given the constitutional prohibitions of a deficit budget.

As stated earlier, this paper is intended to be a first step in the process of developing a workable VAT concept for the State of Michigan. Many relevant issues may have been overlooked or oversimplified, but is our hope that

enough issues have been raised to begin a meaningful dialogue on the Value Added Tax. Only in this way can we hope to avoid the many pitfalls inherent in such a complex undertaking.

APPENDIX B

Brief Biographical Sketch
of
OLIVER OLDMAN

Oliver Oldman is Learned Hand Professor of Law at the Harvard Law School and Director of two programs at the School: the International Tax Program and East Asian Legal Studies. He has been a member of the Law School Faculty since 1955, when he began directing the Tax Program's training activities; was appointed Professor of Law in 1961; and became Director of the International Tax Program in 1964. In 1976 he was appointed Learned Hand Professor of Law. Since 1981 (except for one year) he has also been Director of East Asian Legal Studies. His teaching interests have centered on state and local taxes and finance in the United States and on comparative and international tax law with special emphasis on taxes in the developing countries of the world. During recent academic years he has been teaching the following courses: Comparative Tax Policy, State and Local Taxes and Finance, and The Property Tax. He has also occasionally taught courses on the Public Spending Process and on the Value-Added Tax.

Since 1984 he has also been teaching the new Pacific Community Legal Research Seminar, which emphasizes the international legal aspects of development in Asia. The Seminar is the principal current activity of the Pacific Community Legal Research Project, of which he is Director.

He is co-author (with F.P. Schoettle) of STATE AND LOCAL TAXES AND FINANCE (Foundation Press, Mineola, New York, 1974); co-author (with R.M. Bird) of READINGS ON TAXATION IN DEVELOPING COUNTRIES (John Hopkins Press, Baltimore, 1964; Revised Edition, 1967; and Third Edition, 1975); co-author (with H.J. Aaron, R.M. Bird, and S.L. Kass) of FINANCING URBAN DEVELOPMENT IN MEXICO CITY (Harvard University Press, 1967); co-author (with P.L. Kelley) of READINGS ON INCOME TAX ADMINISTRATION (Foundation Press, 1973); co-author of TAXES ON IMMOVABLE PROPERTY (OECD, 1983); and author of numerous articles in scholarly journals and conference volumes.

Since 1957 he has served as a consultant on tax law and policy to national, state, and city governments in the United States and abroad, and was a member of the Shoup Commission to Venezuela (1958) and the Musgrave Commission to Colombia (1968). He was Director of USAID tax missions to El Salvador (1963-64) and Chile (1964-68). In 1978 he was a Visiting Research Scholar on Local Government Finances while at the Tokyo University Law School. He has recently been an income tax advisor to the Governments of Egypt and Jamaica and a consultant to the Advisory Commission on Taxation and Revenue of the Commonwealth of the Northern Marianas Islands. He is currently Chairman of the Cambridge (Massachusetts) Real Property Assessment Methodology Review Committee, and a tax advisor to the Government of Senegal.

He is currently serving as a member of the Advisory Board of the Inter-American Center of Tax Administrators (CIAT), the Faculty Board of the Lincoln Institute of Land

Policy, the U.S. Council of the International Fiscal Association, the Board of Directors of the National Tax Association, and the Tax Section of the American Bar Association. He is also an Honorary member of the International Association of Assessing Officials. His office address is: Harvard Law School, LW 332, Cambridge, Massachusetts 02138, U.S.A. Telephone: 617-495-4622.

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STATE OF MICHIGAN
IN THE CIRCUIT COURT FOR
THE COUNTY OF INGHAM

CATERPILLAR INC., formerly
CATERPILLAR TRACTOR CO.,

Plaintiff,

vs.

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY,
REVENUE DIVISION,

Defendant.

_____/

File No. 84-9664
-CM and
87-11109-CM

TRIAL
BEFORE THE HONORABLE THOMAS L. BROWN,
CIRCUIT JUDGE
LANSING, MICHIGAN - JULY 28, 1987

APPEARANCES

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Reported By:

Teresa J. Gallegos, CSR-3445

PROFESSOR OLIVER OLDMAN

A witness called by and on behalf of the Plaintiff in the above entitled cause having been duly sworn to testify on his oath as follows at 10:35 p.m.:

THE COURT: Please be seated.

DIRECT EXAMINATION

BY MR. DON S. HARNACK, JD:

Q. Professor Oldman, could you give us a brief summary of your background and experience in the area of value added tax practice?

A. I have been teaching about the value added tax in a couple of courses that I teach at the Harvard law school, beginning – it's been 25 years ago. When the Europeans first started getting involved with it, I got interested in it, because I thought the students ought to know something about what goes on its the rest of the world. I have been a follower of the common market.

In any event, I had, on my staff at that time, a woman, Clara Sullivan, one of the economists, who became the author of the leading treatise on value-added tax. It is the leading textbook on value added tax economics, which she did under the overall supervision of Carl Shoup of Colombia University. He is sometimes called the father of the value added tax, because of his presentation of VAT to Japan back in '49, '50. It was because of the Shoup mission that Japan adopted value added tax in its modernized tax system in the 1950s, though repealed in early '60s.

I have also been a member of the American Bar Association Committee on value added tax, which has operated on and off during the past dozen years depending upon the committees Chairman and whether or not Congress might be considering that same time soon.

The value added tax committee has recently reconstituted itself and is now actively preparing a draft value added tax for discussion by the ABA House of Delegates.

I have had a number of students from developing countries at Harvard Law School and they have been adopting this tax in rapid fire order over the past 15 or 20 years. And I have worked with a number of those students in their thinking about the tax, and have therefore had to have, each year, anywhere from three to a dozen classes on the tax. In one year in 1979, when value added tax was being actively considered by the House Ways and Means Committee, when Congressman Ullman was the chairman of that. In that year, I gave a whole course on it for one semester for not only students, but various people from the outside who came to attend.

There never has been – since that time, I think, a course given in that subject in the US. I wrote one article dealing with value-added tax that is published in the American Bar Association, Income Tax Compliance Volume, when they wanted to know something about the relationship between VAT and income tax from the point of view of enforcement and operation.

(Plaintiff's Exhibit Z marked for identification.)

Q. **(BY MR. HARNACK)** I have for you, Plaintiffs Exhibit Z, can you please identify that for the Court?

A. That contains a brief biographical sketch that I prepared with respect to teaching, research and publication activities in the first couple of pages. Then the remainder of pages one through 10 is a bibliography of various writings that I have done over the years of reports, articles, books and so on.

Mr. Harnack: Your Honor, I would like to offer Plaintiff's Exhibit Z.

The Court: Any objection to Z as in zebra?

Mr. Gomoll: No, Your Honor.

The Court: Doesn't the rule provide Plaintiffs' numbers and Defendants' letters?

Mr. Harnack: Your Honor, we couldn't find that rule, we took a 50 percent chance.

The Court: That's always my problem. A 50-50 chance. I am always wrong.

Mr. Harnack: I would only have one comment aside, Your Honor, not to be too humorous, but Professor Oldman is very, very distinguished, and is younger than he looks. He is a classmate of mine.

The Court: I won't make any comments on that.

(By Mr. Harnack) Professor Oldman, in preparation for your testimony before this court today, did you have an opportunity to examine the Michigan Single Business Tax provisions along with the very recent amendment to the single business tax that labeled the tax an indivisible, value added tax?

A. Yes, I have. I might also say I had been acquainted with development of value added tax concepts from way back in the beginning when Michigan first had the BAT in the late '50s and early '60s, when I began teaching a course in state and local taxation. It was at that time a curiosity to which some attention had to be paid. But I didn't say much about it in the book that we use in teaching materials at that time. The tax was repealed and then it came back to life in 1975, '76. Then it became important, again, to say something about it, because at that time the Advisory Commission on Intergovernmental Relations decided it was important enough to do a full monograph on it.

Others were interested – policy makers from other states are always asking me, well, Michigan has this tax, why don't we do the same thing? Therefore, we were required to pay some attention to it. I've never gone into as much detail, as I have been in preparation for this case and really went through the whole statute including amendments, to see how does it really work.

Q. What, if any, nature of reservation do you have about the structure of the Single Business Tax?

A. The general structure of the Michigan Single Business Tax is, and in the recent legislation was described officially in the statute as, a value-added tax. That is a correct way to describe the tax base in terms of its initial computation, in terms of components.

The major reservations I have is that when the tax then tries to deal with the problem of multi-state or multi-national taxpayers, it has to decide what part of the value-added – of the multi-jurisdictional taxpayer is

Michigan value-added and subject to the tax. And it's the methods used by Michigan to do something about the multi-jurisdictional taxpayer, that I have serious reservations about; whether that method is consistent in any way with a basic notion of what the value-added tax is.

Q. Could you describe those basic notions to us?

A. The value-added tax is a modern form of taxation that has come into prominence when the Europeans decided in establishing the Common Market to have one major tax that would be common to all the different countries. It's in the 1950s when you have that development coming forth.

Before that, you have theoretical writings that go back to T. S. Adams of Yale University at about the end of the first World War, suggesting VAT as a means of general finance. And then when the U.S. Treasury was concerned about financing the second World War, there was again some consideration of it, but not until the Shoup mission recommended it for Japan in 1949 did it begin to get a much more public image.

The Japanese adopted it, but then they postponed its going in effect each year for five years, and then after that, they repealed it before it ever went into effect. Many of you probably heard that in the past year the Japanese government has revived the idea. The administration is in favor of having it, but they have been so far unable to get it through the Diet with all of these trade problems.

And the way the tax has been put in operation in Europe, the principle idea of most of the sponsors has been to use the value-added tax as a way to tax personal

consumption as a form of sales taxation, whereby the tax is collected through an elaborate withholding mechanism as goods and services pass through the economy through production and distribution. So as each firm adds something to the value of what it bought, its purchasing, as each firm buys supplies, raw materials, inputs and then combines its labor and its plant facilities, and its profit-making potential and entrepreneurship with its inputs, it then has an output that has a value that is increased beyond what its inputs were.

There are various documents from the ACIR, I mentioned before two more recent statements that might be worth quoting in terms of what value added is, there is the recent Michigan case, the *Kelvinator* case.

And then I think it's worth just quoting the language of one sentence of that opinion. "The SBT is an additive method of value added taxation which taxes the incremental value of the economic activity by adding the factors of a production by which the taxpayer adds value to its purchased goods and services."

That's the same as what the American Bar Association has stated in a volume of collected articles on the value-added tax, in the ABA Tax Lawyer, the publication arm of the section of the taxation of the ABA.

And in the report of the Special Committee on VAT, which had a number of reports, 1971 to 1977, I quote from the definition that was in there, "the tax base on which a VAT is levied is essentially equivalent to the sum of a

firm's profits and payments for its factors of production not subject to VAT – normally interest, compensation, depreciation and rentals paid." That is, the input on which somebody else has paid VAT is not part of the taxpaying firm's VAT. And its profits and payments include normally, and I quote again, "interest, compensation, depreciation and rentals paid."

So these definitions of value added are widely accepted and understood, both by the policymakers, the theoreticians, and the legislators, and the courts, which have said something about it. And if you think of any one firm, the ordinary way to compute its value added is to just take the sum of its profits and wages. Then, depending upon whether the landlords are taxed on rents as value-added taxpayers or not, you might have rent included in the tax base of a firm which pays that, and it would be the one that adds rental value to the product. In Michigan, however, landlords are value-added taxpayers.

Therefore, to the extent that real properties added value to the goods and services that are produced within it, the use of real property for that purpose, that additional to value-added tax base, through the use of real property, is taxed to the landlords. And therefore, when the company pays rent, it's a tax paid input.

So that one way, in that kind of a situation, the content of value added is essentially profits or income and wages, especially if you have the so-called consumption type of value-added tax where the sum total of all the firms' value added is equal to what amounts to the retail price of the goods and services bought for personal consumption of the buyers. If you add up all the value

added, from the original raw material producers to the final retail, the sum total is equal to the price of the retail goods. So one could look, for example, at national income data, and find in the national income accounts the total of personal consumption in the United States in the given year or in France or Germany or any other country, and that total of personal consumption represents the total value added during that year, which was consumed by people for their own personal purposes.

Now, there is other value added during the year by an economy. And that is the production of capital goods. That's real value. As for the existing value added taxes in Europe today as well as in the developing countries of Latin America, Asia and Africa, which have adopted the value added tax, almost every one of those countries uses the consumption type of value-added tax rather than the gross product type, which is analogous to the US GNP.

The gross national product each year is the sum of the personal consumption that year plus the production of capital goods, that's the GNP. The net national product, the net national income, is that first sum, GNP, minus the amount that is used up that year by wearing out in operation. So the net national product is new personal consumption, new capital production minus previous capital that was used up. And personal consumption subtracted from GNP is the total of new capital produced during that year. If you subtract the total of new capital from the total of GNP, what remains is personal consumption.

Now, the practical problem is to find the personal consumption as it was produced and distributed throughout the economy. And to do that you look at each firm's value added and tax each firm only on its value added. You don't tax the firm on value added by one of its suppliers as the supplier, for example, produces tools and fixtures as we heard about earlier. The supplier that produces that is taxed on adding the value to create those tools and fixtures.

Therefore, when you use the Michigan type of value added tax, which is to add together the components of value added, then you look at the firm's income and the firm's labor, principally, to constitute what the firm's tax base is.

Another way to calculate a firm's tax base for the value added tax is to look at its total sales and then subtract from its total sales its purchases from value added tax paying firms, that is, its purchase of VAT paid inputs. That could be rents, it could be assemblies, tools, supplies, all kinds of fuel, for example. Anything that it buys from other business firms would be subtracted from its sales, and the difference between its sales and taxable input is the value added by the firm. That figure is the same as the additive method would give for the same firm. If you add up its profits and wages, and other non-tax paid inputs, that would equal the same thing.

Michigan has chosen to use the additive approach, because it taxes the value-added tax on the basis of where the value was added to the product. The European approach is different. The European approach assigns to the jurisdiction where the goods are personally consumed,

the right to tax the value added that's included in those goods, as is generally the case with sales taxes.

Sales taxes in the U.S. similarly are levied by the states where the goods are destined. And that so-called destination principle governs the value added tax in Europe and it governs sales taxes of the American states in the United States.

Very few jurisdictions use the other general type of value added tax where you assign to the jurisdiction the right to tax the value added within its jurisdiction, rather than the value added consumed in it jurisdiction for personal purposes.

The states of Brazil are, to my knowledge, the only other place in the world that regularly use the origin type of value added tax. There, each Brazilian state is required to do so under a national law. Each Brazilian state taxes each firm that operates within the state on the value added that that firm produces within that state on an origin basis. When those goods are shipped to another state, the other states then tax the additional value added that might be added to the product, if it is brought into the second state before final sale for personal consumption. Each state keeps revenue based upon the value added within each state, unlike the members of the European common market where each country keeps value added tax revenue in proportion to what is personally consumed in each state, which means that each country in Europe, when goods leave the country, they have the value-added tax removed from them.

Any value added within a country with value taxes, says, in France where goods are produced, when those

goods are shipped to Germany, the exporter gets a complete rebate or refund of every franc of value added tax that is paid by him or his suppliers.

When the goods enter Germany, Germany imposes its value added tax at the border upon the value of the goods at the time they come in. Then if they receive further processing, retailing or distribution services, the additional value added in Germany is subject to tax in Germany. So that approach, which is to tax on a destination basis, is used internationally.

The origin approach is used within a country and Brazil is now the only country that uses the value-added tax at the state level. India has been talking about using that tax for the Indian states, but it does not now do so. A number of American states have talked about doing it, but Michigan is the only one that has an operational law. West Virginia had a tax that went through its legislature, but was vetoed by its governor. Michigan remains the only state that has the tax and it taxes on the origin basis and uses the additive method for computing.

Sorry if I went on too long on that.

Q. No, I think the background is very helpful, when we get down to your description, just what is the Michigan Single Business Tax. You say it's origin based and uses the additive method. Could you describe your understanding of precisely how Michigan creates its VAT tax base?

A. What Michigan does, and it's somewhat similar to what Congressman Ullman had proposed to do when a

Federal VAT was proposed, is to start off with tax information that Michigan taxpayers already have. The starting point on the Michigan SBT or VAT is to look at the Federal taxable income of a taxpayer and then use that as the profit element. The SBT then makes some changes to the profit, as well as adds to it labor wage or compensation costs, which are the major components of the value added tax bases. Income or profit and wages are the two main components of the Michigan value added tax. The rent and interest components are taxed directly to those firms which add value by way of rent, or by way of using property, real property, or which add value through the borrowing of funds, so that the banks get taxed in Michigan on this additive basis unlike the way they are treated in Europe, but like the way they are treated in one or two other countries, such as in Israel.

So for a Michigan firm, you start off with its income, not its income tax, but its income as reported for Federal tax purposes. And then to income is added the wages. But because the income comes under the Federal tax law, it includes allowance for depreciation, which is not a part of the value added tax base.

Federal income has the depreciation deduction removed from it for purposes of the Michigan SBT, and that's removed by adding back to the tax base the depreciation that's been deducted for Federal tax purposes.

So what remains of income is what might be called income for value added tax purposes, which is the usual view of what income is, subtracting all the usual costs of goods sold from gross receipts with the exception of

depreciation, which is an accounting concept for how to account for capital goods.

But since the value added tax that tries to tax only consumption does not tax capital goods, you want to remove capital goods from the tax base altogether. And the way to do that with respect to the depreciation element of capital goods, if you start off with Federal taxable income, is just to add it (the cost of capital goods) back in. That's what the Michigan tax does. It also makes a few other adjustments to Federal income tax accounts, which are necessary in order to get what you might call pure value added income. And it makes those changes as well.

All of that is necessary in order to get the concept of value added ingrained into the base, which Michigan is trying to do. It has announced it has a value added tax and tried systematically to identify for each firm the figures in its accounts which add up to or constitute components of value added. The problem that arises is when you have multi-state and multi-national companies. You start with Federal income, you get rid of the depreciation, you bring back in all the wages. That's the crucial computation that is involved. But a company that has wages, compensation outside of Michigan, then has to get some kind of consideration given to its worldwide or countrywide accounts. It has to have something done to its countrywide or multi-national or worldwide accounts in order to identify which parts of the company's value-added was done in Michigan, how much of the company's total value added was added in Michigan. And there Michigan uses as a unique approach by just carrying over its old income tax apportionment formula and saying, well, we will just apply that three-factor formula of

property, payrolls and sales to the value added tax base, meaning income plus compensation. That's a strange animal in the world of value added tax thinking.

In the world of value-added tax, you know where most of the value added is, in fact, added, because you know where the workers are. So you don't have to use the formula, you take the wages paid for services performed in a location, and say that's the value added by compensation in that area. If you are interested in taking the value added by property, you would then look to where the property is, where it's being used, so you would know where it is and you could calculate its rental. If it's rental property or rent is paid, you know where the rent is. That's the value added that year for that company.

But where, as the Michigan tax purports to do, you are not taxing the rental value of capital, you have excluded capital from the base. In a sense, you can say property is not really relevant to the value added tax base, except as it annually contributes to the output and contributes to profit, so to speak. And in that sense, property production leads to gross receipts in the end. Services and property render, year-to-year, greater sales, and that becomes a component of your profits and that's how it adds to your value added. But you are not taxing the machinery and equipment and billings directly under a consumption type of value added tax.

Q. What effect does inclusion of the sales factor as part of the SBT three-factor formula ordinarily have on the preapportioned taxed base?

A. Well, sales represent, you might say, the consummation of the entire value adding process. The sales price

of goods represents the total value added by the firms that sell those goods, plus value added by all the firms which supplied input to the taxable firm that we are now taxing. So the sales of the firm include not only its value added, but also the value added by the firm's suppliers.

If what you are trying to identify is the location of the firm's value added, then sales – the location of sales would basically be irrelevant. It's the components of value added that you are trying to locate, not the sales. The sales are the sum total, the result of the value adding process. But the sales don't tell you where the value was added. Therefore, it's an extraneous factor to determining the geographical location of the value added. The components are the profit and the wages. They are the primary components. The wages can be located easily by knowing where the work was done. So one doesn't need a formula at all for that.

Income, even the value added concept of income, which is without depreciation, that is gross receipts minus cost of goods sold, without depreciation, even that concept of the income is not so easy to pinpoint geographicaliy. A firm's income is the result of a lot of activity in different places, including even some sales activity. Therefore, it can be seen that income can be subjected to some kind of a formula in order to get a rough approximation of where it arose.

It would be easy to identify the place where income arises, if all you are talking about is a piece of real estate that is rented; the location of that pinpoints where that income is from. But where firms are engaged in multi-state and multi-national activities, it's more difficult to

decide where the geographical location of the firm's income is, even though it's easy to decide where its payroll or compensation is located.

For value added tax purposes, it seems to me much better to eliminate the sales factor from the three-factor formula in trying to geographically pinpoint where the income arises in a value added sense and property and payroll can be identified with the value-adding process. In so far, however, as you are not trying to tax the value added by property, payroll itself is all you really need for the purpose of deciding where the income element of the value-added tax base is located.

One might look at payroll as the key item in a tax like the Michigan tax, where payroll is the major component of the tax base.

Q. Have you had an opportunity, Professor Oldman, to review some of the litigation that has resulted in the application of the SBT, the *Jones & Laughlin* case?

A. Right, I have read the *Jones & Laughlin* case, The *Kelvinator* case, the *Trinova* case, but it is the *Jones & Laughlin* case and *Trinova* case are the ones that involve these issues of apportionment of geographical location of value added and of trying to pinpoint the extent to which value is added in Michigan and therefore subject to the Michigan SBT. The result in the *J & L* cases seems, to me, to be a sound one, and a necessary way of interpreting and applying what the Legislature inserted into the Act by way of geographical division of the value-added tax base provisions. It generally has its three-factor formula, but then it has safety or relief provisions in order to cover

the multitude of cases where the three-factor formula doesn't conform to reality.

So the statute allows for other methods to be used than a three-factor formulation and the relief provisions that are there would allow, for example, the separate accounts for payroll to be used to identify the geographical location of value added by payroll and compensation. Since the Legislature provided a scheme that allows for flexibility for the value added to conform to reality, then it would seem as if it's the obligation of the Department of Treasury in Michigan and the courts to make that work. If the Department of the Treasury applies the statute in a way in which an artificial result is achieved as was proposed in the *J & L* case, then the Courts come in and bring reality into the picture, and say, quite correctly, that you can't locate where the payroll element or components of value added are by looking at where the sales took place, or where the sales ended up.

You locate payroll by looking at where the people worked. The Court there came out with a pragmatic result which accords with the reality of that taxpayer's accounts. Seems to me that a system which allows for that kind of flexibility, if administered that way, solves the problems of the multi-state or the multi-jurisdictional taxpayer by judicious interpretation and application of Section 69, which provides this wide range of possible applications of the geographical division of value-added tax provisions.

Q. Probably better stated, at least than by me. It provided that prior to the recent amendment to the SBT, which would appear, would it not, in your opinion, to

place a limitation on what the administrators can do with that Act?

A. That provision – the amendment is very short. To my mind, the most useful thing that it does is to reconfirm that the Legislature had in mind a value-added tax concept in the first place. The original statute didn't use the language of value added tax in the statutory language, although all the legislative history indicated that's what they wanted it to do. The amending the statute, which is curative, it reaffirms, it now puts in the statute, that it's a value-added tax. The fact that it is an indivisible value added tax does not add anything. Any tax is an indivisible tax, it's a value-added tax, it's not a gross receipts tax, it's not a sales tax, it's not a some other tax, it is a value-added tax. And the word indivisible there doesn't clarify anything that wasn't there previously, in my judgment, in terms of the value added tax concept.

Q. As I understand your testimony, then, it would be your opinion that the sales factor is not appropriate for utilization in the value-added tax?

A. Right, it is my opinion that the sales factor, that sales themselves, represent the ultimate goal of the value adding process, and that to use that to geographically locate where the value was added provides a misleading geographic picture of where the value-adding process takes place.

When a jurisdiction purports only to tax value added within its jurisdiction, that originates within its state or country, and it has taxpayers who operate in more than one jurisdiction, it has to face up to the problem of geographical division of the tax base. The way to do that

is not by looking at where the sales take place, you use sales to apportion gross receipts taxes, and you use sales in conventional corporate income tax as a handy representation of the demand factor in producing profit. But to use sales in the value-added tax is almost a contradiction in terms, because it's not really related to the value added tax process.

Q. Do I also understand your testimony to be, that it's your opinion, that only those items which cannot be specifically sourced to a given jurisdiction would be appropriate for the application of a formula?

A. Right, where the information was for a component of value added, such as compensation, or if depreciation were to be made a component, that if one knows the location of a component of value added, then the accounts that show that give all the evidence that one needs of that value added. With respect to the more intangible types of contact or components of the value added tax base, then one might want to use proxies or formulas to make an approximation of where the value added tax base is. And for that purpose, you want to look at value adding processes, production and distribution processes. Where they take place, where people get paid, and where property is used to generate value.

Q. Professor Oldman, I am now going to state a hypothetical question to you. If you have any questions at all relative to the facts, don't hesitate to interrupt me.

A. I may take some notes if there are some numbers.

Q. Let's assume it's the year 1981, we assume that a taxpayer, in this case Caterpillar, has neither production facilities nor distribution facilities in the state of Michigan. Assume that Caterpillar's Michigan property in 1981 has a total value of six million dollars, and its total property throughout the world is six billion dollars, resulting in a property factor of 1/10th of one percent attributable to Michigan. Assume that Caterpillar's Michigan payroll is 79 thousand dollars.

A. 79 thousand?

Q. 79 thousand dollars.

A. Right.

Q. And Caterpillar's total payroll is 2.5 billion dollars resulting in a payroll factor of 3/1000th of one percent attributable to Michigan payroll.

Assume further that the sales of product into Michigan are 70 million dollars and that total sales of Caterpillar worldwide are 7 billion dollars resulting in a sales factor of approximately one percent attributable to Michigan.

Assume that the average of these three factors is approximately 3/10ths of one percent.

Assume further that by use of the three-factor formula, the Michigan Revenue Department computes compensation taxable in Michigan. The amount of compensation is thereby increased from 3/1000th of one percent, that's based on the actual compensation paid in Michigan, to 3/10ths of one percent, an increase of 100 times, not 100 percent. An increase of 100 times.

A. From 3/1000ths of one percent?

Q. To 3/10ths of one percent.

A. To 3/10ths, which would be 100 times?

Q. 100 times. Assume that the property factor, which otherwise would measure the use of personal property in the state, is increased from 1/10th of one percent to 3/10ths of one percent, an increase of three times. Those are all the facts I am preparing to submit to you at this time; do you have any questions?

A. It's quite clear.

Q. I haven't asked a question. I just want to know.

A. I have questions about the facts.

Q. You have questions about the facts?

A. No, I think I have got them down right.

Q. Do you have an opinion as to whether or not the statutory method of apportionment contained in the single business tax, using the three-factor formula, properly reflects the values added by Caterpillar's activities in Michigan?

A. I do have an opinion, and it seems to me quite clear that the Michigan three-factor formula applied to these facts brings about results completely inconsistent with the idea of the value-added tax on an origin principle using the additive method. The way you know that is that the payroll compensation is 79,000 in Michigan. To use the compensation factor or to use as the compensation component of value added, any figure beyond 79,000 would misrepresent Caterpillar's value added within

Michigan from the use of labor. That would be a total misrepresentation. The measure of it is the 100 times factor. It's 100 times greater than the value added through the use of payroll and compensation within the state, and it's a clear distortion of what a value-added tax base is trying to identifying in a geographical sense.

One could say the same thing with respect to depreciation to the extent depreciation of property enters into the tax base. There you have a three-times multiple in relation to the six million of property that's within the state. And instead what gets attributed essentially when you increase from 1/10th of one percent to the 3/10ths of one percent is six million becomes 18 million. And that doesn't make any sense in the context of the value added tax.

Q. I take it, then, it is your conclusion that utilization of the SBT three-factor formula in this case would result in a taxation of values out of all appropriate proportion to the company's value added in Michigan, which is used to measure its business activity?

A. It's completely out of appropriate proportion to its value-added activities within the State of Michigan as compared with its value-added activities outside of Michigan.

Mr. Harnack: Thank you, Professor Oldman, that completes my direct examination.

The Court: Mr. Gomoll?

Mr. Gomoll: Can we have a short recess.

The Court: Sure, 10 minutes?

Mr. Gomoll: 10 minutes would be fine.

(Recess from 10:20 a.m. to 10:30 a.m.).

The Court: Mr. Gomoll?

Mr. Gomoll: If it please the Court, on cross-examination of Mr. Oldman, Mr. Roesch is going to do the initial cross-examination.

The Court: All right, Mr. Roesch?

CROSS-EXAMINATION

By Mr. Richard R. Roesch, JD:

Q. Professor Oldman, you testified that you had familiarity with the business activities tax, which was levied from '53 to '67 in Michigan. Could you explain to me how the tax computation under the business activities tax was made?

A. Under the old act?

Q. Yes, the business activity tax 1953 through '67?

A. I did not go back and review that specifically, recently. But I do have recollection that it looked – it brought in some of the value added tax kind of thinking in the design of the base at that time.

Q. That was not my question. Let me put the question directly. Was it an additive-type tax?

A. I guess I don't remember, but I think if I had to think back, I would say that it was – I just don't remember what it was at that time, but it would be easy enough to take a look at it.

Q. Yes, it would be easy enough to find it. You testified there were several ways of – there were at least two ways of measuring value added by the enterprise, the additive method, and then you also spoke of the deductive method.

A. Subtractive.

Q. Subtractive method, correct. Professor, are you familiar with the Supreme Court case in Michigan in 1961 under the business activities tax, *Armco versus State of Michigan*?

A. I have read that case, yes.

Q. If I gave you a few examples, the last question you answered was a hypothetical, based upon facts which are peculiar to Caterpillar, and as I remember them, the facts were assuming that we had property of 1/10th of one percent in Michigan. Those were the exact facts in *Armco* also, sir.

The next was assume that we had 3/1000ths of one percent of payroll. I would only make variation here. Assume it were 1/40,000th rather than 3/1000ths, 1/40,000th of payroll.

A. 1/40,000th of one percent?

Q. Yes.

A. Okay.

Q. And on the sales figure, instead of using one percent, we shall use 8.7 percent. And now I shall ask you, under those circumstances, would an attribution of tax base to the State under the business activities tax,

which was this forerunner of the SBT of 2.9 percent, slightly above 2.9 percent, which is the sum of the three factors divided by three. Would that, in your opinion, be an improper measure of Michigan activity?

A. Assuming those figures are correct, and the 2.9 percent is the average, and that that's the way it was reached, would I say it would be improper? Yes.

Q. But you are perhaps familiar with the outcome of *Armco Steel* case of the Michigan Supreme Court, which was in favor of the VAT, would you disagree with that outcome?

A. Yes.

Q. You testified as to the amendment just recently made to by Public Act 39 of this year, to Section 69 of the single business tax. You specifically said that very little was added by the idea that this is an indivisible value added type of tax except to characterize the tax as being in a different concept, and the privilege of earning that income, for example; am I correct in saying that?

A. Well, I did not talk about the privilege.

Q. No.

A. Not at all. And what I was characterizing was the base of the tax, which has the name single business tax.

Q. Yes.

A. And has various other language. But in terms of identifying what the base is to which the tax rate is ultimately applied, the Amendatory Act says this is a

value-added tax, and that's not news, because it's always been referred to as a value-added tax.

Q. Correct. But it does use the word indivisible.

A. It does use the world indivisible, right.

Q. And it uses perhaps in contrast to and not a combination or series of several smaller taxes?

A. That, to me, is a contradiction in terms.

Q. That is as contraction in terms?

A. Right.

Q. Is that a contradiction because you believe you can source value added by looking at the elements of the tax base?

A. Correct, that's correct with respect to those components of value added such as compensation, and such as depreciation with respect to tangible goods, with respect to both of those, you know, and can identify from the records where the value is being added through where the people are working and where the property is being used. So to the extent that they are a part of the tax case, the geographical sourcing is almost – is self-identified.

With respect to those parts and those components that go up to make up the sum total of value added, it may be helpful to use approximations or formulas with respect to others. But with respect to those two, those are two easily identified geographically, to justify the use of any kind of a formula instead of the specific allocation where they are.

Q. Professor, both the ABA, you spoke of the committee on value-added taxation, and the court case in Michigan that you read from, would you agree that a value added tax is upon incremental addition to value, I will call it incremental additions to cost, between when a product comes in my door and when a product leaves the door. In other words, it's upon the incremental value added at any stage or production or distribution; is that correct?

A. By someone who is identified under the Act as a taxpayer?

Q. Correct.

A. Yes.

Q. And if there never is a disposition or sale of a product, is there any activity subject to taxation?

A. As a conceptual matter in terms of the value-added tax base, you have to face the same kind of problem that you face in income taxes with the concept of realization and what to do with it, and the accounting device that deals with that is inventory, and both income taxes and value added taxes in the end have to decide how to handle inventory in terms of not whether it is value-added, but when is value-added going to be taken into account for the purpose of applying the tax right to it.

Q. Yes. You are familiar with the single business tax. Do you remember offhand the definition of the word "activities" in that tax?

A. I know it's in there, but I don't remember the precise definition.

Q. Well, the definition is basically, in terms of the transfer of legal or equitable title to property, so forth, before a single business tax liability arises. My question is, must there be such an activity, namely sales, when we are talking of products rather than rendition of services?

A. The answer is yes.

Q. So sales is important as to the single business tax; is it not?

A. Sales is important in terms of identifying in which year, in which tax time period, value added is going to be accounted for, and it's important in the sense of realization that you have something to measure, but it's not the amount of the sale, it's the occurrence of the sale.

Q. Professor, what is in the single business tax, what did the Legislature identify as the taxable subject?

A. The tax base?

Q. Not the tax base, but the taxable subject.

A. What difference do you intend?

Q. What is the taxable subject under the New York franchise tax? What's the taxable subject under the New York franchise?

A. In other words, it's the franchise.

Q. It's the franchise. And yet when you go to the base, what is the base?

A. The measure of the tax may be income or it could be gross receipts.

Q. Correct, in other words, it's a tax for the doing of business measured by net income. Now, I go back to my question, the subject of the tax here, what did the Legislature identify as its – as the subject that it was reaching?

A. The idea of a single tax on business.

Q. Yes. In fact, the taxing statute says this is a tax upon the doing of business and not upon income, specifically, income tax. Michigan is the only state that has a doing business tax based upon a value added principle.

A. Yes.

Q. Other states, what do they use?

A. Income and gross receipts are the two most frequently used measures of business activity.

Q. I see. And in those cases, let's say in the New York franchise statute, how is the privilege of doing business by a multi-state enterprise divided up? How is it attributed to the state?

A. Since the base is income, they then have the problem of the geographical division of income of the multijurisdictional taxpayer. And that then gets divided up by formulas. Not all states have exactly the same formulas, but all the income-taxing states use a formula, and those formulas always have relief provisions in because the possibility of a formula is always that it might not work in a particular application. So there are relief provisions to depart from the formula where that seems to be appropriate.

Q. Do the majority of states use a three-factor formula?

A. Yes, they do. They also use special identification for particular types of income that are easy to identify like real estate.

Q. The business/non-business dichotomy, which authorized your division, I presume you are referring to the Michigan apportionment formula in the single business tax, basically, a copy of that in the uniform division of income for tax purposes act?

A. I don't think I would call is a copy, but it has many similarities to it. And indeed its derivation was in connection with its former income tax and the apportionment formula in its former income tax was just carried over to the VAT whether or not it was thoughtfully carried over or carried over because it was available and nobody wanted to worry about designing a custom made formula for the VAT. But in fact its source was not a design for VAT, its source was designed for income tax.

Q. Did the former – well, we touched on it before, did the former business-activities tax also contain the three-factor apportionment formula; did it not?

A. Yes, it did.

Q. And the franchise tax for the privilege of doing business in Michigan –

A. Also.

Q. – also had that formula. And indeed the intangible tax upon business which also was replaced; did that also have a three-factor formula?

A. I haven't looked at that one, but it wouldn't be surprising to find out.

Q. It did?

A. Because it's for intangibles where these formulas have its greatest use.

Q. Would it surprise you to be told that in 1965 all Michigan taxing statutes on business were amended to insert therein that you had the three-factor evenly weighed formula, I am just asking, would that surprise you?

A. No.

Q. So it actually predated the Michigan income tax?

THE COURT: Is that a question?

MR. ROESCH: Yes, and he nodded and the answer would be . . .

THE WITNESS: Well, predated one.

Q. **(BY MR. ROESCH)** The Michigan income tax 1968?

A. Well, there was a Michigan income tax even before that.

Q. No.

A. Is that the first one?

Q. 1968, January 1, corporations, October '67 on individuals. Section 69 of the SBT, the relief provision. What is its purpose?

A. To identify – to allow the taxpayer and the administration to bring in other methods of geographically

dividing the value-added tax base where the statutory three-factor formula does not accord with the facts of that particular firm.

Q. Is the Section 69 a relief provision?

A. In my judgment, it's a combination of relief and accuracy of the supervision. In other words, the objective is to get at where the value added is added and the language of the provision is to give a necessary flexibility in that process.

Q. Is it supposed to respond to unique circumstances or just to the run-of-the-mill cases?

A. It's supposed to respond to whatever a case demands. Whether it's by industry, by company, it's supposed to be responsive to the situation. And not necessarily unique to any situation where the three-factor formula doesn't do, doesn't properly or only geographically divide the base.

Q. Professor, we have 7,000 multi-state single business taxpayers in the state. They all have a compensation component of the base. Under your analysis of sourcing, should each one of these 7,000 separately account for compensation?

A. To the extent that the separate accounting for compensation produces a result that is significantly different from what the three-factor formula produces, they should separately account.

Q. Aren't we really – are you not really turning a tax on the subject of doing business into a tax on compensation, a tax on depreciation, a tax upon interest paid,

rentals paid? In other words, are you not subdividing the tax by your source and theory?

A. The Michigan statute defines what the measure of the tax is, which is valued added and value added consists of those components which are also identified by the statutes. I am not changing anything. I am just making consistent the application of the concept of the tax base to the multi-state taxpayer.

Q. Let's go to the subtractive method for a minute. What if, instead of the additive method, the single business tax had the subtraction method, just as it had under the business activities tax; what would your answer be then? Couldn't you separate – would you strictly account for compensation, but just not add it up with the other elements?

A. When a jurisdiction wants to do what Michigan wants to do, which is to have origin based value-added tax of the consumption type, then you would have to take – you would have to convert the subtractive method for those taxpayers for whom your approach to dividing up the tax based doesn't produce a proper result. Then you would have to look at what the components of that taxpayer's tax base would be, because you're looking at the countrywide or worldwide accounts when you are using the subtractive method. And to locate where that value was added, you would then have to have more information once you decide that's what you want to do. It was Michigan that decided to do that, and then got itself in this situation.

Q. In other words, let me get this straight, under a subtractive type computation, a subtraction computation,

you would still say since the difference, the end result done here on the subtraction is the value added, and since I can say that value is added by compensation, by interest paid, by profit, by depreciation, would you still make the same argument that one should source the value added?

A. I would make the same argument, unless the system that you were using was the system that the European countries and that other countries use, which is to say that the value added is only going to be taxed to the place of consumption.

If you are going to use an origin type approach, which Michigan said that it wanted to use in large part in order to employ a measure of the services provided for government to business, and they look at value added as one way of approximating the benefits that businesses get from that the value added in Michigan, approximates the benefits measure of the benefits that businesses get from government expenditures, and that's a rational approach to it, and you build that in to the cost structure, but it does require identifying value added in Michigan.

Q. In other words, when you're saying rational consistency leads you to the result that Michigan has an origin based consumption type additive method value-added tax, and logic consistency, therefore, permits sourcing the elements, permits us to look, in other words, as you put it, where the value's actually added?

A. Just to straighten out where logical consistency begins and ends, it's the Michigan statute that decides if they are going to use the origin approach, not logical consistency. That's a legislative determination that they

want production and distribution activity when it takes place in Michigan to be subject to a state tax, whether that activity is engaged in by corporations, partnerships, individuals, it doesn't make any difference. But if it's in Michigan, then the value added will be measured and will be subject to tax. And if that system is to be adopted, then to be consistent with it in terms of geographical division of the tax base, sourcing by looking at specific components is the best way to start off.

Only where you don't know the source of the components, would you then look to the design of the formula, that gives you a reasonable approximation for that component. And it's there where the logical consistency is once you decide to have that kind of tax base, and in my judgment the rest follows.

Q. Is it not possible that the Legislature simply said for the privilege of doing business instead of an income tax, instead of a net worth tax, we will have a value added type tax, value added no matter where in this world, a portion thereof attributed to Michigan; isn't it possible that that's what they say?

A. Anything is possible for a legislature to try and do. Whether it is successful in doing that in terms of getting the willing cooperation of taxpayers, on the other hand, and whether it's successful in avoiding Congress' constitutional barriers to their tax policies, that's a different question. But if the Legislature wants to design something that was non-existent before, whatever kind of a label it puts on it, that's neither an income tax, nor a gross receipts tax, nor a value added tax, but we want it

and we will define it this way. If they want to do it, they can do this, then they take their risk.

Q. Professor Oldman, do you believe sourcing constitutionally is required?

A. In the case of the value added tax, I think that that properly, that's a result at the state level, if the tax is levied at the state level and the origin approach is used. In other words, if what Michigan says it's doing is what they want to do, then I would think that a result that's consistent with those components of the value-added tax, which can be sourced, would be constitutionally required.

Q. A state is free to choose its tax system, is it?

A. Within constitutional limits. Therefore, it can satisfy itself with an income tax, franchise tax, gross receipts tax. It can choose any one of these. It can use easily any of those taxes that have already been used and have already been defined and litigated so that we know what the dimensions are. When you do something different, then you are charting new territory.

Q. So Michigan doesn't have an income tax, does it, on corporations?

A. On corporations?

Q. It doesn't have an intangibles tax on corporate portfolios and it does not have a franchise tax, does it?

A. I don't know.

Q. No, it doesn't. It replaced all these with a single tax, a single business tax. The Legislature was free to

choose to do that. Whether or not they did is, of course, subject to constitutional challenge.

A. Right.

Q. Caterpillar does business from Illinois and Illinois has not chosen a value added tax, but has chosen to measure their activities and to tax them by an income tax. How do they apportion to Illinois their income?

A. I suppose that Illinois uses a three-factor formula.

Q. Correct.

A. But they also must, if they are going to use an income tax, they have to use an income tax not only for multi-state taxpayers, but for all taxpayers and Michigan can use an income tax too, but they have to use everything, they can't pick out-of-state payers for income tax and in-state ones for value added tax.

Q. In fact, what does Michigan do? Do we impose our value-added tax, our single business tax on instate as well as out-of-state industry?

A. Sure, you apply it to everybody. But the rules aren't always exactly the same.

Q. How are the rules?

THE COURT: Break for lunch.

MR. ROESCH: Sure.

(Lunch break from 12:00 to 1:30 p.m.)

(Court, Counsel and all parties present.)

THE COURT: Please be seated. All right, Mr. Roesch.

Q. **(BY MR. ROESCH)** Professor Oldman. Is capital employed in production, property employed production, is that one of the sources of income?

A. It's a source of adding value to products as the capital gets used up.

Q. Correct. You also testified that an apportionment by a three-factor formula of income seemed logical. Now, is it logical because property contributes to production of income and payroll does and so does the marketplace; is that the idea?

A. In the case of income?

Q. Yes.

A. Geographical location. The three-factor formula is not so much logical as it is a practical compromise, which is workable as long as you have a mechanism for dealing with the case that it doesn't fit. So it's a starting point. It's not by any means an acceptable finishing point to say that income taxes in all cases should be apportioned by a three-factor formula. That would not be logical.

Q. So it isn't a relationship to the source which makes the three-factor employable in determining income of multi-state corporations?

A. It's a rough attempt to get at the source, not by measuring it receipt by receipt the way Federal income tax law does in separate accounting, not by the way all countries do through separate accounting. But the states long argued that that's too difficult to apply because the rates are relatively small to justify maintaining auditing

staffs to regulate the transfer prices used in separate accounting.

It's a complex matter. With the rates low, you accept the compromises that are generated by three-factor or two factor formulas. Some states use four and five-factors, you accept that compromise as long as the rates are small and the impact on the tax liability is not so great as to make the taxpayer upset enough to complain or make the administrator upset enough because the formula happens to produce very little revenue and what should be done is separate accounting, as the administrators sometimes assert and claim under the income tax. That's why I say that a three-factor formula or indeed any formula is not a logical complete solution to the geographical determination of income in the income tax area.

Q. In other words, it is just a very rough approximation of, I don't want to use the word source, very rough approximation of source?

A. Of source, it is exactly what it tries to do. You are trying to identify the source in each state, which will then become the tax base. You can do it bit-by-bit or as a whole. If you do it by formula as a whole, you run the risk of distorting a particular taxpayer's geographical division of income.

Q. Now, in your words, you had reservations, is the exact word, reservations about the Michigan three-factor formula applied to a value-added tax.

A. I think I said a major reservation.

Q. Would you have a major reservation if net income were judged by one factor alone, namely, the marketplace, by the sales?

A. I would have a reservation that it would be undesirable to apportion net income only by the sales factor. That doesn't mean that it might not work in certain cases. But to say that it would be a model to be set up for adoption, say, by all of the 50 states, I would think it inappropriate.

Q. Indeed you have said the majority of states use the three-factor?

A. Right.

Q. Is that what you meant by model, basically?

A. Many of them, but some don't go for the business/non-business distinction, they just put everything in one pile.

Q. Yes, I understand. Are you familiar with a *Moorman* case? *Moorman* versus –

A. *Moorman Manufacturing*?

Q. Which upheld a net income tax apportionment with a one-factor formula; is that right?

A. Yes, but it did uphold it in a context in which the taxpayer did not show that it was being treated differently in other states, so as to cause a disproportionate tax being imposed by either. In that case it was all done on the face of the statute.

Q. Professor, does not the Supreme Court in a footnote of that case point out 44 states use a three-factor

formula? In other words, other states did treat them differently, they did not use a one-factor formula?

THE COURT: Is that a question?

MR. ROESCH: That's a rhetorical statement that is a question.

THE COURT: I didn't hear an answer.

THE WITNESS: They pointed out other states have different formulas, what was not in the record in that case was how it applied to a particular taxpayer to lead to an unconstitutional result. There was no evidence on that.

Q. (BY MR. ROESCH) I understand. The Supreme Court in that case said that the taxpayer had not overcome the presumption of constitutionality. They had not shown there that there was unconstitutionality.

A. But the Supreme Court, in the *General Motors versus District of Columbia* case, said that the use of a one-factor sales formula was not good, but there it was interpreting the District of Columbia statutes enacted by Congress and not ruling as a constitutional matter.

Q. What were you saying, that the privilege of doing business includes the privilege of manufacturing?

A. Yes.

Q. So the employment of capital, that would be included?

A. Yes.

Q. And the employment of labor?

A. Yes.

Q. And it also would include the making of sales, would it not?

A. Yes, but I suppose it requires some elaboration. To note that when a statute uses language like privilege, even through that's now outmoded by the *Complete Auto Transit* case, or when a statute more importantly uses language like business activity, that statutory language is in there for the purpose of showing to the world that there is a legal basis for asserting the power to tax, that the government is entitled to get paid for services which it renders. It is the earning of income or the generating of economic activity which is the subject of the tax.

But having identified a reason for taxing to cover the costs of government service that was benefiting business, then the Michigan statute, as do other statutes, whether they are privilege taxes or otherwise, then go on to define how that right to tax is to be exercised in terms of defining a tax base, and then a rate which is going to be applied to that tax base. The relevance of privilege and of business activity is only to provide the necessary legal excuse for taxing in the first place. After that one must look at the design of the tax that the law provides for measuring what the tax liability is going to be. Having decided that, you can tax.

Now the question is, how do we do it. And in this situation, the tax we have before us today, the single business tax, their value-added tax, the value-added base is the avowed measure of the right to engage in business activity, which is an acknowledged proper excuse for asserting the tax burden.

Q. I fully agree with you. And we also know what the value added is of any enterprise, we know what the worldwide system value is; do we not?

A. Yes.

Q. And Michigan then purportedly uses an apportionment device to get its share of the value added worldwide.

A. But Michigan defines its share in a very peculiar manner. And, in my judgment, in a very discriminatory and biased manner by including the sales factor in it. The sales factor has the effect with respect to instate producers in Michigan of diluting the importance of their payroll and property in Michigan by using a sales factor to take out of Michigan a part of the payroll and a part of the property, to take them out of the tax base, because there are sales outside of the State.

The converse happen with respect to out-of-state producers. They, under the Michigan statute, are forced to bring into the instate tax base a proportion of their out-of-state payroll and property that is measured by their sales in the state. And the effect, the combined effect of the way the sales factor works, is to, in my judgment, generate a discriminatory result as between the way the tax impacts on in-state producers and out-of state producers.

Q. Isn't this the same argument that was made in the Willis report of 1964, once you do away with the sales factor? Are you familiar with it?

A. Very much.

Q. Isn't the Willis report –

A. But the Willis report, in terms of which factors to use, got into the debate largely between groups of economists, but also others practically involved with apportioning interstate income. They got into the debate over the extent to which income is supply-side activities, production, or demand-side activities, the creation of the market.

The Willis committee in the end came out with the recommendation that the best way to apportion interstate income is by a two-factor formula, property and payroll. They rejected the inclusion of the sales factor largely on administrative and practical grounds.

As a whole, when you look at the country as a whole, the only thing that's really important for the efficient operation of the United States common market is that there be a uniform system and the uniform system could be a three-factor formula for income. But then it wouldn't be administered properly. And therefore they went for a two-factor formula because they thought it could be administered uniformly as well as have an overall uniform division of the base.

Q. Which leads me to another question. When we speak of the sales factor, were sales always attributed to the destination state? If sale was made from Ohio to the state of Michigan, was it always attributed to the destination?

A. To this day there is disagreement of the states as to which state the sale should be assigned to for purposes of including it in the numerator of that state's sales factor. While the predominant rule is destination, it's by no means the uniform rule.

Q. Indeed, I would ask you, we mentioned the New York franchise tax measured net income. Prior to 1965, how did it treat inter-state sales, sales from one state into New York, or from New York out to New Jersey?

A. I don't recall 1967 being a change year for New York, but apparently it was. It may have been the year that – I am not even sure what their current sales factor is, that they had changed it.

Q. The current sales factor is the destination sales factor?

A. It's destination, but the question of weight on it.

Q. It's evenly weighed. No, my point that I was going to make was this, in the Michigan franchise tax, in the original business activities tax, sales were attributed 50 percent to origin, and 50 percent to destination. And that was the New York treatment also.

My question that I have is this, were not the practical difficulties in devising uniform formulas behind the idea of getting rid of a sales factor and going into a two-factor in the Willis report, was that one of the major considerations?

A. It was not so much reducing the number of factors, because they could have made it sales and property or sales and payroll. It wasn't a reduction from three to two that was important.

The problem was the disagreement over the meaning and interpretation of the sales factor, plus the fact that almost any interpretation of the sales factor, except an origin based one, would attribute sales to some states that could not or would not exercise jurisdiction. The thought

was that some of the income might therefore fall in a nowhere land and not be taxed by any state. This subject is what eliminated the sales factor. Because with property and payroll, there would always be jurisdiction by any state that would have property or payroll jurisdiction to tax, they would use the two-factor formula. So 100 percent, no more and no less of the tax base, would be apportioned among the states. If they fell in a state that didn't exercise its right to tax, then there would be no tax by that state on their share of the national tax base.

Q. But even today, the majority of states still apply the three-factor formula, still true?

A. Yes, still a confusing situation as described in the Willis report as of the early 1960s. The situation continues unabated because Congress has not yet acted in this.

Q. Are you familiar with *Ford Motor Company versus Beauchamp*, B-e-a-u-c-h-a-m-p?

A. No – I am not familiar with that, we didn't happen to discuss that.

Q. Yes, are you familiar with the apportionment factor or factors under that Texas franchise tax?

A. I haven't looked at that tax in particular.

Q. Your strong reservations with apportionment of value added are due to the fact that you believe you can source or you can assign to a certain state components of value added?

A. Yes, in particular, the payroll, which is the most important source of value added. It is the most important

component of value added. It's one which can be geographically pinpointed very easily with the exception maybe of some marginal cases of a few individuals who may be constantly on the move.

But with that exception, the geographical location is easy. Similarly with respect to the extent to which property adds value to a firm's output, and property does have that characteristic, even after the depreciation adjustment, and after the capital acquisition deduction still the property does produce as it gets used up. And to the extent that property yields value-added tax base, it, too, can be specifically located.

Q. How many states in the union accept a separate accounting or a sourcing theory for attribution of tax base?

A. Are you talking about income tax now?

Q. Talking income tax. Talking franchise tax.

A. But the franchise taxes, for the most part, are income taxes. Only in few cases are they based on capital stock. Maybe one or two cases measure by gross receipts. And in those cases, the formulas are generally used as the method for geographically dividing the base.

Q. Okay. I will give you a hypothetical. I have a taxpayer who has 10-percent of his property in Michigan, 10 percent of his payroll in Michigan, 10 percent of his sales in Michigan. He also very typically has 80 percent of the value added as compensation element. In that event, how would you allow the state of Michigan, or how do you think that the state of Michigan should tax this particular taxpayer?

A. In this case, given those figures of your example, it makes no difference whether the three factors are averaged together to make 10 percent or whether you just look at the 10 percent payroll factor, and apply that to its tax base, which is 80 percent payroll compensation anyway.

And that's why Michigan can enact a three-factor formula, as a general starting point and presume that in a case, even if it isn't the average normal case, the factors may be fairly evenly distributed. If, when they get averaged together, the differences are relatively small, you don't bother trying to refine for those differences, you just apply it and the result in terms of tax burden is not very different, whether you use a direct source, a specific allocation, or a three-factor formula. The problem arises in the example that we had in the testimony earlier, where each of the three factors are dramatically different than each of the other two.

Q. We will make it simpler, we will make it one percent property, one percent payroll, and 10 percent sales in Michigan. And once again, 80 percent is the so-called compensation component.

A. It's – in that case, as I said before, that averaging those three together, which would give you an average of four percent, where that would distort the value-added tax base, that can be identified as in Michigan. This taxpayer has his – well, in this case with the one percent, we know that its main place of production is out-of-state, because ninety-nine percent of property and payroll are out-of-state. So in that case, what is happening is the ninety-nine percent of property and payroll are out of

state. The State is saying we are nevertheless going to treat it as if there is only 96 percent out-of-state, and the other four percent we are going to say is instate.

Q. But are we taxing compensation, is the state of Michigan purportedly taxing compensation?

A. In that example, Michigan is taxing, in very real terms, not only compensation, but out-of-state compensation, which constitutes 80 percent of the value added tax base. That's exactly what it's doing and that's the whole trouble, that's the distortion.

Q. But that doesn't mean anything when the Legislature says indivisible value added, meaning the overall value added.

A. In my judgment it makes no difference, because when you are taking 100 percent of the value added or 80 percent of the value added, you can't very well say that that four percent of the payroll is in the state when ninety-nine percent of it is out-of-state. And it's a contradiction of reality to produce a result that's inconsistent with the facts.

Q. It's a contradiction of reality if I had a tax upon the payroll, would it not be?

A. A tax on value added is a tax on payroll to a very important extent.

Q. This is where we disagree. A tax on value added is a tax upon the incremental markup at any stage of production.

A. And that's largely constituted by payroll. The markup is, in your example, where there is an 80 percent

payroll, 80 percent of the markup is due to payroll, to compensation.

Q. That is when you look at the – that is purely a sourcing theory?

A. It's a fact, it's a fact. You don't need a label legal or otherwise on it. 80 percent of the difference between sales and taxable input is compensation. And that's what the books show. And that is the heart of value added.

Q. So what you are really saying is, if Michigan imposed an income tax for the privilege of doing business, it can use a three-factor formula?

A. If it imposed an income tax.

Q. Or if it imposed a franchise tax, as it did?

A. It could use a three-factor formula.

Q. And yet because it says it imposes a value added tax, the words, these many words, value added tax, all of a sudden disallows the state to use the three-factor formula?

A. Exactly.

Q. That's what you are saying? You were referring earlier to *Auto Transit, Complete Auto Transit*. What case did that specifically overrule?

A. The *Spector* case with respect to direct taxes on the privilege of engaging in business.

Q. The *Spector* case. Because the *Spector* case was a tax imposed upon the privilege of doing business interstate, intrastate, because of the label. The *Spector* decision went against the state of Connecticut; did it not?

A. Right.

Q. And so looking beyond the label, *Complete Auto Transit* says we look beyond the label of what the tax is, we look at how it overrules *Spector*.

A further question, is your disagreement with the Michigan single business tax based upon your perception that it – that the formula unfairly attributes to Michigan, or is it based upon your idea that application of the three-factor formula is unconstitutional?

A. I am not sure that there is a difference between those two. But the three-factor formula is inconsistent with the idea of value added as a way to measure where the geographical location of value added is.

Q. With the idea of geographical assignment of the value added?

A. Right. What Michigan says it's doing and wants to do is tax only the value added that is in Michigan. It's a tax on value added in Michigan.

Q. Is that what the law says?

A. That's what the law means. I think in reading the law, that's what it says, that it's a tax on business activity measured by value added in Michigan.

Q. It's tax upon the doing of business, measured by business activities in turn measured by value added, I agree. Value added apportioned to Michigan.

Then by apportionment formula, I go back to *Moorman*. If income arises from the employment of property, payroll and sales, how can a court find an apportionment

formula constitutional takes no account of any property, no account of any payroll, and very simply zeroes in on sales?

A. It's the peculiar posture of that case as presented to the Supreme Court that brought about that result. The Supreme Court is not saying that that's good. It's merely saying that given the way that case appeared, Iowa can get away with doing it, and I think that's the way one has to understand it. And if you are asking me will Michigan likewise get away with what it is doing here with value added tax, I will be very skeptical. It's enough different from *Moorman* that this case or another case like it should go to the Supreme Court. It is going to be a battle, unless Michigan interprets its statute. The way of the *J & L* Court of Appeals, which is the nice way for the Court in the end to rescue the Legislature and Department of Treasury in terms of interpreting the statute.

Q. I disagree entirely with the way the *J & L* Court did it, the *J & L* Court rescued nobody. And I think in the end –

THE COURT: I thought we were involved in questions and answer.

MR. ROESCH: Right, but incomplete opinion as to what the courts do.

THE COURT: I guess that's arguing.

Q. **(BY MR. ROESCH)** I am not about to argue. To revert, Michigan had a corporate income tax whereby income was the base, and it was apportioned to Michigan by an evenly weighed three-factor formula of property, payroll and sales.

A. Yes.

Q. And that was okay. And had a franchise tax on the doing of business, which used a similar formula, or the same formula. And it had a tax, a property tax, upon the ownership of intangibles of the portfolios of corporations, for example, which the single business tax did replace these taxes; did the single business tax replace the income tax?

A. The same act repealed all of those and introduced single business tax.

Q. Yes. And this tax, because it is labeled a value-added tax, may not use the three-factor formulation to apportion worldwide value added by a business by multi-state or multi-national business; is that true?

A. I am saying that a value-added tax, when the origin approach is being used rather than the destination approach, as used in most other places, that if you are taxing value added having its origin in Michigan, then it's completely inappropriate and inaccurate to use a three-factor formula with respect to a multi-state taxpayer. And that the value-added tax base is enough different from the income tax that you can't just skip from one to the other both, as a matter of theoretical design of the tax, and I think ultimately as a matter of the way the Federal system works, in terms of its constitutional dimensions.

Q. But if every state of the union has an income or franchise tax, and uses a three-factor formula, and Michigan, instead of an income or franchise tax, has a single business tax, with a three-factor formulation, does that result in multiple taxation?

A. It's not the inconsistency between other states' use of income tax and misuse of the VAT that causes Michigan any problem. What causes Michigan a problem is that for a variety of reasons it decided that it did not want a corporate income tax. Yet it wanted to raise that amount of money by some other measure.

The VAT offered an opportunity to expand the tax base beyond corporations to include partnerships and individuals engaged in all kinds of economic activity including the rendering or providing of services. So, the tax base could go well beyond the income or the value added of corporations to the value added by anybody engaged in business in the state. That gave an opportunity to broaden the base and lower the rates. And that meant the companies that might be subject to heavy tax liabilities under the income tax during the years when their profits were high would avoid that ever happening to them. They would pay consistently low taxes whether or not they made profits, because the tax base would always include the payroll and the value added through the use of this property. It would give some stability to the revenue that income taxes don't give. It's one of its decided advantages. It would reduce discrimination between corporate forms of doing business and partnership and other forms of doing business. It was another advantage, and it was an advantage to see all business or activity pay its fair share of government cost through taxation in good years and bad years.

So it's the idea behind it. That's all. I think wrapped up in the single notion of this is a tax that's on business activity of all kinds.

Then came the problem at some point, and there I just don't know what went on in the mind of the designers at the time. They had to decide, well, what do you do about taxpayers who are engaged in multi-jurisdictional activity. For the ones who are only within Michigan, it's no problem. Their entire property, payroll, their entire value added, in whatever form is going to be subject 100 percent to the tax anyway. There the law was designed to provide special forms of relief for some Michigan taxpayers. Because when they computed their tax liability under a general value-added tax with origin, some taxpayers found that the tax base was more, for example, than 50 percent of their gross receipts, and the tax looked more like a gross receipts tax than a value added tax. So the Legislature acted then and said, well, if your total value added is in excess of 50 percent of your gross receipts, we will limit the tax base to 50 percent of the gross receipts.

Then other taxpayers came along and said, look, we have all this production going on in this state. We are the lifeblood of the state. Our payroll is 90 percent of our value added, and if you tax us, we won't be in such a good competitive position. And the State accommodated them by saying that to the extent that their compensation payroll exceeded, at first, I think it was 65 –

Q. Three –

A. Sixty-three percent. Then ultimately exceeded 65 percent. To the extent that compensation exceeded that, you could reduce your tax base in order not to be taxed on any more than 65 percent of your payroll, that's an accommodation to those taxpayers. They did that. While

it's a generally available provision there, they were alert to that, because instate taxpayers were in there figuring things out and they came in with their complaint. Farmers came in with theirs and you have the detailed structure of the statute taking care of all the political pressure points, except other state taxpayers were either asleep at the switch or weren't listened to.

Q. Were you around the day when –

A. No, I wasn't around.

Q. So this is a certain amount of speculation?

A. No, some of it was written up when you read the legislative background of political debates as written up in a number of different articles. You have to look far and wide for anybody writing about how did the three-factor formula come in there, other than saying they had it in there.

Q. Let's go back. You said before Michigan had a three-factor formula in its franchise tax, in its income tax, in its tangible tax. And since these taxes were repealed, it has gone in the single business tax so the three-factor formula – was the three-factor formula specifically designed for the single business tax?

A. Not at all, at least so far as I know I haven't seen anything that says it was. Since it's a copy of what was there already, I take it for granted it was not designed for the SBT.

Q. In fact it's something else than the 50 percent gross receipts limit. You said you were familiar with the business activities tax. Did the business activities tax, did it also have a 63 percent gross receipts limit?

A. I just don't remember. I know there was an adjustment for payroll.

Q. Excess compensation?

A. Right, excess compensation.

Q. Would it surprise you if I told you it also had a 50 percent gross receipts limit?

A. I wouldn't be surprised at all.

Q. It's another approach. I asked you once before when using the subtractive method starting with gross receipts, and then starting with all the payments for the material, supplies, and then took the difference, as value added, your argument would still be that you can attribute value added geographically?

A. It's a short method of computing value added and it's the method that in fact is used by other countries in large part because they don't use any form of apportionment at all. What they do is they use that and you calculate the tax. If the goods are going to be exported, you get the tax back. If the goods stay in the country, the tax is paid, so there is never any occasion to worry about which jurisdiction is taxing except in export/import sales, and then it is 100 percent in and 100 percent out, it's never apportionment.

Q. Is the idea of sourcing compensation, is that the same as saying one can separately account for compensation?

A. Right.

Q. That's the same?

A. It's another way to verbalize it.

Q. Has separate accounting ever been required under any state tax, to your knowledge?

A. Yes. Some of the statutes give the tax administration the power to institute separate accounting for particular taxpayers where the tax administration thinks the formula gives the wrong result and in some states the state has the power to impose it with the taxpayer not having any choice.

Q. Is formulary apportionment a rule and separate accounting the exception, or is it the other way around?

A. That also varies from state to state. It's not uniform. Mostly, formula apportionment is the starting point. And then to the extent that that seems to produce a result that is unreasonable in the light of a particular fact, you look for relief. Whether it's a different formula, or using separate accounting, or some combination, all of these are possibilities. The starting point is much more often the formula than separate accounting in the American states.

Q. Are you familiar with Michigan cases of *Payne & Dollan* and *Donovan Construction Company*, cases under our single business tax?

A. I have just seen the summaries of them in the Michigan Compiled Laws, in the annotated versions, but I haven't actually read those particular cases.

Q. Would you have any inkling whether these cases deal with the question whether the formulary apportionment is the rule?

A. In so far as I have heard about the world of construction activity, for example, where construction companies have long been used to using a different method of accounting, completed contracts, separating one job from another, or in some cases they even create a separate corporation for each job, when that happens there may be much less problem than where it's just an accounting arrangement, and then the question is, will the State of Michigan recognize when a large construction company separately accounts for a particular contract, which involves Michigan, and keep out of their accounting for value added tax purposes, all the rest of their construction business around the country and of the rest of the world. And there I understand Michigan has been willing to use the separate construction contract as an operable basis for computing value added.

I wouldn't be surprised to find that analogous to the uniform business concept under income tax treatment, that Michigan has also said that where a conglomerate, for example, has several different kinds of business activity altogether, that Michigan might treat each one of those separately, and account for its value added separately, rather than force the company to aggregate all of its unrelated and independent different lines of business activity. I can see that happening. To me that just illustrates that the problem is an endemic problem.

What I am saying here is that in any other situation where the facts are at odds with the results produced by the formula, then Michigan must also recognize that as different and design an arrangement to accommodate that. And the proper arrangement, it seems to me, is some

form of special allocation, when it becomes easy to identify components of value added as payroll and property.

Q. From your experience, would you judge whether of the 7,000 multi-state taxpayers, a large number or only a handful could show by a sourcing or separate accounting theory entitlement to Section 69 relief?

A. I would expect a significant portion to find that they would have – that they would see a discrepancy between the result dictated by the application of the formula and what their books show with respect to property and payroll.

I would also suspect that some of those companies, of the 7,000 companies, find that inadvertently the tax base is much smaller than they might have expected it to be, because they happen to be in a situation where they have some more payroll and property in Michigan, because it's a state where they acquire but don't sell much. And even though they are not Michigan companies, Michigan may be the location of where they get and produce certain kinds of things, and that those companies would find that like a big instate Michigan producer, they find their tax liability under the three-factor formula is less than it would be if property and payroll was specifically apportioned and then of course they are not going to say anything about it at all, they are pleased as punch. They are bound to be some of the 7,000 who are in that category.

You will not hear from them although the administration might identify some of them and find that it's not getting enough revenue from them. I say I can't blame them because it's Michigan value added. They have the

payroll and property there but they don't sell in the state. They bring it (the product) to another part of the company (outside Michigan) where it gets embodied in a further state of processing and sold somewhere else. They have no sales in Michigan at all in that kind of a case.

And the sales factor then takes 1/3 of their property and payroll, because their sales in Michigan is zero, it takes 1/3 of the property and payroll and apportions that outside the state, so the tax base is less than it would be if you just taxed them on value added as measured by property and payroll in the state. They are very pleased with it. Why Michigan's tax lets them get away with it, I don't know. I would think Michigan is a good place to produce.

Q. Are you familiar with the capital acquisition deduction of the single business tax?

A. To some extent. I read about it.

Q. Does Michigan use a different formula for figuring the capital acquisition deduction or does it use a three-factor formula?

A. It uses a two-factor formula of property and payroll.

Q. It does?

A. Right.

Q. That is specifically provided for by the Legislature?

A. Right.

Q. The Legislature makes any provision for a one-factor or two-factor attribution of compensation element?

A. I don't recall seeing that. No, there may be some exception in some of the cases, but I don't remember seeing it in the statute.

Q. In other words, the tax base, as such, except for the capital acquisition deduction, is apportioned by a three-factor formula?

A. Right, and the capital acquisition deduction is a subtraction from gross value added. It's not a strange subtraction in a state that presumably wants to encourage development in the state. What is surprising is that they didn't except the producers of the capital in Michigan from value added tax at all. But because they are taxed, they (the state) then again has to get the tax burden out of the tax base and the benefit is given to the buyers of these capital goods.

Q. My point, Professor, is the Legislature knew very well to use a two-factor formula for one thing, for the capital acquisition encouragement. But they made no provision for variation from the three-factor to any element of the value-added tax base; am I correct?

A. I am not sure how the two-factor formula got in. But looking at the two together, it seems like a conscious and deliberate decision, which then makes the distortion and the result in the use of the sales factor that I pointed out deliberate, rather than accidental.

Q. So no deliberate attempt was made to give compensation element any different treatment than a profit element of value added or any other element?

A. Right.

MR. ROESCH: Correct. Terry, do you want to take over? Thank you.

THE WITNESS: Thank you.

THE COURT: Further cross-examination?

CONT'D. CROSS-EXAMINATION

BY MR. TERRY P. GOMOLL, JD:

Q. Professor Oldman, I want to try and clear up some things. I think one of the things that Mr. Roesch was getting at, is under the business activities tax, the state of Michigan uses the subtractive method for determining the tax base. And under the single business tax, the State uses the additive method. Does it make any difference in your analysis which method is used?

A. Either way, you have to make some adjustments for the accounts that are, in effect, the starting point for the taxpayer's taxes, and the additive method allows the easy use of your Federal tax accounts as a starting point.

And when you are doing that, the natural thing to do, rather than starting with gross receipts, if you are starting with Federal income tax base is then to add to the income component of value added the other components, and that's what the statute proceeds to do.

So it's an orderly, sensible way to do it. And mainly, in the end, when you compare the two closely together, to figure computations and calculations, it also allows the Legislature to make more special exceptions, if it wants to for certain combinations of value added components,

whether for farmers or manufacturers, or professionals or others.

Q. I guess what I am focusing on in the subtractive method, there is no mention of compensation. We start with gross receipts and subtract costs of goods sold.

A. It's a shortcut for identifying compensation plus profit and some other components.

Q. There is no mention of compensation. Does that make any difference to your analysis when you use the subtractive method or additive?

A. No.

Q. Some of the commentators have described the value added tax as a measure of the economic size of the business. In an article by Mr. James Haughey in the Wayne Law Review, he said the Legislature desired to establish a neutral tax system which leads to business paying tax in proportion to its economic size without interference from the nature of the tax in internal business decisions.

Another commentator, Mr. Lewis Kasischke stated in the same law review, "Theoretically, the SBT is a value added tax and a measure of the tax is the use of labor and capital. The tax base computation is designed to calculate the contribution each business makes to the total economy. In economic terms, this contribution is the economic size of the business. Each business will pay tax proportionate to its economic size." Would you agree with that type of analysis?

A. I have no quarrel with that because, in what you read, economic size is defined in terms of value added, so

economic size is a proxy for value added. As long as that is true, you are not talking gross receipts, gross assets or gross anything else. Economic size defined in terms of value added is stated to be, and I agree that it is, a proper place for reflecting the participation, you might say, of a big firm in the economy. And I have no problem.

Q. Well, let's look at it, then, from this perspective. The Legislature has indicated specifically that the tax is on the privilege of doing business, and the measure is the value added, or the economic size. Okay. So the Legislature says, Well, we are going to tax you on the privilege of doing business and measure it by economic size.

Now, as you testify, there is a problem with multistate businesses. We can't tax on the full amount of value added on this ball of wax called value added or economic size, so we have to find some way of attributing part of that to Michigan. And they say, well, the method we used before is a three-factor formula. So we are going to take this total value added in the economy and slice it up by the three-factor apportionment formula. We are not trying to source components of the value added tax, this whole ball of wax, we are not trying to divide it up in into components. We are going to take this whole thing and say so much of this value added is assigned to Michigan by the apportionment formula. Is there any problem with that analysis?

A. Yes, as I indicated, the entire thrust of my testimony is that it's inappropriate to use the sales factor in making that kind of apportionment of value added, even though the sales factor may have some contribution to

the income in an income tax or to some aspect even of the income components of value added.

But with respect to the other parts of value added, which is the heart of the value-added tax, sales really have little to say, except to the extent that sales people are on the staff of the company, working in Michigan and doing the selling themselves. Unlike what we heard described with respect to Caterpillar, where Caterpillar turns over the saturation of the Michigan market to an independent dealer, and Caterpillar staff only has two, three, four people who service them, and the customers then all have the value added through the selling operation of Caterpillar's product. All of that is value added by the dealers and, of course, that's 100 percent subject to value added tax by Michigan and quite appropriately so.

And if Caterpillar decided to have its own dealership, a wholly owned dealership rather than use an independent dealer, then all of the value added now added by the independent dealer and taxed by Michigan would become part of Caterpillar's tax base and Caterpillar would have no quarrel with that because that would be their value added, but that's already paying tax, it's just been handled by the dealers in that sort of situation.

And the sales activity of Caterpillar in Michigan is virtually negligible in terms of the value added components. You have the salaries of a few people that are involved, and that contributes to sales. But the real sales activity is carried out by others whose value added is subject to tax.

Q. You say one year Caterpillar sales to the Michigan customers are 93 million dollars. Now, that's not the amount that each customer sells?

A. They sell much more than that.

Q. Yes.

A. And the differences between the 93 million the dealers in Michigan pay, and what they get from what they sell, which might be another 50 million. They might get 150 total, so the difference between the 93 and 150 would be 57 million of additional value added in Michigan, a combination of profit sales, payroll, facilities for storing and selling, so on. All of the value added between the time Caterpillar sells into the state and the time when the dealers resell is already subject to tax.

One might theorize, for example, the possibility, and I am sure that there are some states where this might in fact be true where Caterpillar has no presence at all in terms of property and payroll. But nevertheless, a great – a significant volume of its products are sold in the states. An independent dealer in state knowing about the nature of the demands for Caterpillar products just orders and buys them from Peoria and takes over care of them, as we heard before shipment, FOB Peoria.

Anyway, so the independent dealer instate buys from Caterpillar and resells, so on. In that case, Caterpillar has no value added in the state and the state would have no basis for applying value added tax.

Indeed, Michigan law would not apply because the nexus provision under Michigan law would not apply to Caterpillar under that situation. Because Caterpillar does

have a little bit of nexus in the form of a few employees and some property it owns, it then finds itself in the position where it's legally required to file the value added tax return, and it does so. At that point it has to identify what is the value that Caterpillars adds in Michigan. And that value is very easy to measure. The property and the payroll were put on the record earlier today and it's very straightforward.

Q. I think we are – the analysis I was looking at, we were looking at this value added as one solid concept. You are now breaking it up in component parts of Michigan value added. We are going to measure the business privilege by this total value of wax called value added, we are not going to divide it up into compensation and depreciation. We are not going to try to source it. We are just going to divide it, attribute to Michigan by using a formula, apportionment three-factor formula, which is used in most states.

A. On the one hand, you say you are not going to divide it up, Michigan is not going to divide it up, in the next breath you say, Yes, we are going to divide it up geographically among the states. To say you are going to divide it up for one purpose and not for another purpose is unequal. It's a way to get more measure, and it has to be examined in that kind of context.

Q. Well, in an income tax concept, do Federal constitutional requirements require states to source income?

A. The Federal constitutional requirements only say that the states must apportion or allocate the income in some reasonable way. And then the Court has ruled on one after the other, a large number of formulas used in

the income tax context. Some it struck down, some it's upheld.

Since there haven't been any value-added tax cases put before the Court, we don't know what in the end they are going to say there. But there is no reason to assume that what's right for income tax is going to be constitutionally right for the value added tax.

We have seen in the income tax when you compare with income tax cases and sales tax cases and gross receipts tax cases, you find you can't apportion gross receipts taxes by a three-factor formula. For example, gross receipts taxes and sales taxes are on an all or none proposition or basis.

Q. I want to focus on income tax. Say Caterpillar has a large plant, a manufacturing plant in Ohio. And it sells the plant. It has a large capital gain. Makes a lot of income off that. Can Illinois include that income in a tax base which Illinois taxes even though we know who the source of that income is?

A. To the extent that that's a small part of its total income during the year in question, you end up with essentially de minimis problems. To the extent that in that year, that would be the only element of profit in that year; suppose that all the rest of its activity yielded a zero income loss result and that the only income it had that year was the capital gain from the sale of property in Ohio. I would think that the Supreme Court would strike down the application of the three-factor formula to that income.

Q. Has it done so in any case that you are aware of?

A. I am not aware of any case that's presented that problem, but I don't know any state that would be foolish enough to assert the tax in that kind of case. That's why Section 69 type relief provisions are found in all of the income tax statutes when it comes to apportionment in the different cases.

Q. Back to my analysis on the value added as one ball of wax. Now, you are saying it's made up of component parts. But just suppose the Legislature looked at this as just one way to measure. We are not looking at compensation that goes into it. But this is one ball of wax and the Constitution requires the states divide that up. Michigan can't tax the whole thing. So they either require separate accounting or some type of apportionment device. So the Legislature says, Well, we will just take this ball of wax and apply our apportionment formula to it. Is there anything wrong with that analysis?

A. As I said before, I think it's completely wrong to use the sales factor in that kind of apportionment.

Q. Now, in that context, in that regard, you testified that the use of the sales factor shifts the tax burden from instate producers to outside producers, which sell into Michigan; is that correct?

A. It reduces the tax burden on instate producers. It dilutes, really, the measure of the property and payroll in the state of instate producers. And it exaggerated the amount of property and payroll in the state of out-of-state producers. And in that sense, it's a discriminatory application of an apportionment factor, that it evidently has the result of favoring instate production, and of burdening out-of-state production.

Q. Isn't that criticism applied to any state which uses that three-factor formulation? When you have a sales factor, the effect of the sales factor is always to reduce the tax burden for instate producers and increase the tax burden for outstate producers?

A. But only with respect to income, rather than with respect to the components of the value-added tax base. And that's enough difference that in my judgment it's wrong to use that kind of a formula, when what you are apportioning is not income, it's only with respect to income where you can accept the use of three-factor formulas to apportion.

Q. But you have the same effect, it reduces the instate?

A. Right, it does have the effect.

THE COURT: Let's takes a 10, 15 minute recess.

(Recess taken from 3:00 to 3:10 p.m.)

THE COURT: Please be seated. All right.

Q. (BY MR. GOMOLL) Professor Oldman, just as a general rule, is the use of apportionment formula, which shifts the tax burden from instate producers to outside producers, per se, unconstitutional?

A. I am not quite sure what that means. It would raise a question, at least, that would bring into discussion whether or not the reason for the shift and the way it actually operates turns out to be an unfair method of apportionment.

Q. Okay. Is the use of sales, the effect of the sales factor, to shift the burden from instate producers to out-of-state producers?

A. Shifting the burden from one to the other isn't, I think, quite the way I put it, or that it should be put. The use of the sales factor has the effect of reducing the tax burden on instate producers from what it would be if there were no sales factor. And at the same time, it has the effect of increasing the tax burden on out-of-state producers from what it would be if there were no sales factors used. If one would look at where the value added has its origin and use that as the norm, then the standard effect of the sales factor is to benefit instate producers and to put the burden on out-of-state producers. But to say it shifted from one way to the other, reducing one and increasing the other, in a way, that is discriminatory.

Q. You are saying it's discriminatory, but it has the same effect in income tax?

A. But in income tax you are measuring something different.

Q. Forget the base.

A. In income tax you don't know where the income has its source. In the typical case, if you knew where it had its source you wouldn't be able to use the formulas either. In the value-added context, most of the value added, namely the payroll, you do know where it is located, where the value is added to the firm's value-added tax base. And since you know that, you can't artifically live by statute, deny it, and say we are not going to treat it as if it's out-of-state at all. We are going

to move it into the state for the use of Michigan taxpayers.

I seriously raise the question of the constitutionality, it changes the tax from the value added tax genre to some new invention without a name, so to speak, because nobody else has tried to do it. To me, it's a deliberate distortion of state practice in taxes in order to accomplish an unconstitutional advantage, in my view.

Q. It wasn't an answer to my question. The question was, by the use of the sales factor, in any apportionment formula, whether it's income or franchise, the franchise measured by that income, or franchise measured by net worth, doesn't the use of the sales factor shift and increase the tax burden of out-of-state producers and reduce the tax burden of instate producers?

A. The use of the sales factor in effect brings in sales as a part of the tax base. Since sales are not a part of the value-added tax base.

Q. I didn't mention value added tax.

A. In so far, just looking at the income tax situation, since sales are one factor in producing the income, and all you are trying to measure is income, and you are unsure about the extent to which sales are a factor in producing income, the formula is an approximation for estimating where the geographical location of the income is.

Q. Sir, I didn't have an answer to the question. What's the effect of using the sales factor of apportionment formula? Doesn't that increase the burden of out-of-state producers and reduce the tax burden of in-state producers? Yes or no?

MR. HARNACK: Objection, Your Honor.

THE WITNESS: You can't answer that question directly.

MR. HARNACK: Objection, Your Honor. I think the witness is attempting to answer. He was interrupted. He may not be giving the answer that Mr. Gomoll wants, but he is answering the question.

THE COURT: He is trying to.

THE WITNESS: You have to answer that question in terms of compared to what. In answer to value-added tax I compared to what the value-added tax base would be in relationship to the sales factor. In the case of the income tax when you want to talk about increasing the burden on the out-of state manufacturer and decreasing the burden on the instate manufacturer, the burden of the income tax increasing as compared to what? You didn't describe what your standard was for increasing.

Q. **(BY MR. GOMOLL)** I think in regard to the value-added tax, you testified that the use of the sales factor increased the burden of the out-of-state producer, and decreased the burden of the instate producer.

A. I said as compared with what the burden would be, if you look at the value added as shown by the information that is available in the books, I have a comparison there. When you talk increase, it has to be increase with respect to something, its increase of the burden compared to what it would have been if you did not use a sales factor in trying geographically locate the value-added tax base.

Q. And the income tax situation, I think maybe what you are saying is if you had a two-factor formula of property and payroll, instead of three-factor formula with sales in it, would the burden increase for out-of-state producers as compared to a two-factor formula. And the answer would be yes. And would the burden decrease the income tax burden for an instate producer as compared to a two-factor formula? The answer would also be yes.

Now, is it unconstitutional to use the sales factor to achieve that result?

A. In this case you are talking about income and you are trying to locate the income, and in comparing the two formulas, both of them represent reasonable approximations of where the income is located. In the case of the value added taxation formula that has sales factor in it, does not geographically located value added in any reasonable way, given the nature of what a value added tax base is.

Q. Wasn't that the same criticism of the sales factor for apportioning income in the Willis report, that it wasn't a good factor to use in place of source of income?

MR. HARNACK: Objection, Your Honor. I have no objection to the State having two attorneys cross-examining Professor Oldman, but as I recall, Mr. Roesch asked precisely the same question about the Willis report.

THE COURT: Well, it's cross-examination. I certainly don't have total recall whether Mr. Roesch asked the same question. And it is examination. They can ask the same question 14 different ways in cross-examination.

Whether it's the same question or no, I don't know. Go ahead.

THE WITNESS: Do you want to repeat the question?

Q. **(BY MR. GOMOLL)** Wasn't that same criticism in the Willis report that the sales factor didn't reflect the source of income?

A. The Willis report, as I said before, did not reach that conclusion. The Willis report was attempting to reach a satisfactory solution in a situation in which one school of thought said that the sales factor should be one of the measures of the geographical location of income and another school said the other and the Willis committee had to come out with some approach to be uniform. Its initial conclusion was that either one would be perfectly all right as long as it was adopted uniformly. It then opted for the two-factor formula. Not because the sales factor is always bad, but because in the world of practical administration, it would save a lot of time, effort, and energy and assure a more even-handed operation of the income tax, and I think that's what I said before.

Q. On your direct examination, I think you testified what the single business taxes is the values added to the product. Now, what was the basis for that conclusion?

A. The value added tax, the Michigan single business tax, as it has been written in the statute, and as it has been described and summarized in the numerous articles that have written about it, describe it as a tax on the origin basis of value added, the place where the value is added. In cases of payroll and property, that's very easy

to identify. You know where that value is added, it's where these two factors of production are put to use. Therefore, there is relatively little discussion, almost no discussion in the literature about the Michigan tax, about the nature of, or the reason for, and the validity of the three-factor formula. It hasn't been analyzed. As far as I know, that's happening today for the first time.

Q. Is there anything in the single business tax itself to which you can point that would indicate that the Legislature intended to source component parts of the tax base?

A. The legislature intended to tax the value added in Michigan. And then it provided a formula subject to a number of exceptions, adjustments, and relief provisions as a way to determine the proportion of a multistate company's total value added which is to be assigned to Michigan.

Q. Is there anything in the act that you can point to that says compensation shall be attributed to the state where compensation is paid?

A. In so far as the act deals with compensation as an add on, and a specific item included in the value added tax base by implication, then the question is, where does it get included. Well, the place where the compensation is put to use, where the workers are earning the compensation, and it's so clear it seems to me that when compensation is added to the Federal income tax starting point, and that the tax is on Michigan value added, it's so clear that the place where the compensation is paid for the work done there is the place where it's added. It would

be redundant to add any more. To me the statute says that.

Q. Well, Section 45 of the single business tax says all of the tax base shall be apportioned to this state. Then by the use of the three-factor formula, it says all of the tax base. It doesn't indicate that the Legislature wanted to source component parts of the tax base, does it?

A. I think what it said there is that all of the tax base will be apportioned in accord with Section 69 and Section 69 is a complex of provisions starting off with the three factor formula.

Q. No, it doesn't say that. It says – let me read it. All of the tax base other than the tax base derived principally from transportation, financial or insurance carrier services or specifically allocated shall be apportioned to this state by multiplying the tax base by a fraction of the numerator of which is the property factor plus the payroll factor, plus the sales factor and the denominator, which is three.

A. That's the beginning of Section 69, you really have o read the whole section.

Q. No, it's Section 45.

A. Okay. But section 69 has to be read along with it as a part of the same statute in order to give that meaning.

Q. Now, as I understand your position, the income components of the value-added tax base should be apportioned, but other components like compensation can be specifically allocated?

A. I said the income components can either be apportioned on the basis of the formula, or through the use of separate accounting and transfer pricing, which is the way the Federal Government does it, and the way the other countries do it, but income could also be apportioned by formula the way most states do it in the United States today. Either one is a reasonable way to do it, and has been accepted in the real world of state practice. The use of the formula, the three-factor formula in the world of international practice, has not been accepted and is vigorously contested as to whether or not it's an acceptable means in international law.

Q. When you do that, though, aren't you really imposing separate taxes? You have tax on apportioned income and a tax on allocated compensation, a tax on allocated interest. You are breaking up the tax base into these little parts.

A. You are not breaking it up any more than you are breaking it up among the states when you are dealing with a multi-state enterprise. You are supposed to break it up. There is no single ball of wax when you deal with an enterprise that is involved with more than one state, not to mention more than one country. The question is how many ways are you going to treat it, you can't cut up the tax base in a way that that contrasts with the actual facts the taxpayer brings to bear.

Q. Can you separately account for a value added tax base within the state, would that be possible?

A. Would it be possible, certainly.

Q. How would you go –

A. It already appears in the books of probably most of the 7,000 people, 7,000 taxpayers that you have talked about. Because they know where their compensation is paid. They have to file for unemployment insurance and other records which identify in which state their compensation is to be treated, so that geographical apportionment is already done with respect to payroll.

With respect to property, it's usually subject to property taxes somewhere and most property is subject to tax in only one place unless it moves around, then it might be apportioned among the places where it is located. So that information is routine with respect to the major components of value added. The only one, as I have said several times today, that causes any trouble is income. And for the same reasons that we have hundreds of cases in the states, and in the Supreme Court dealing with the limits, the constitutional limits of when and how a state can choose how to apportion income, it is a particularly complex area of its own where there is a wide range of acceptable approaches to geographically locating the income component of value added, just as there would be for locating income as a tax base when it's the only tax base.

I am not quarreling with using formulas for the income components. In this particular case, as the stipulation of facts indicate, we are mostly dealing with years in which there is no income. So you don't have to worry about the use of apportionment formula at all if there is no income.

Q. Well, couldn't we determine a Michigan income for Caterpillar by taking its sales and subtracting Michigan expenses?

A. I doubt that you would be able to do that. But you could put it differently. I will withdraw that answer and say that if you have separate accounts that identified income, kept according to the recognized methods of keeping separate accounts, you would have a geographical set of separate accounts for which you could apply the tax on that basis. You would also have to make that available, of course, to the taxpayers. You couldn't do just simply that, but you could do that as part of an income tax, but then you must apply the income tax to everybody else too. If you want to do it with respect to only the income components of the value-added tax as a part of the value added tax, it also must be part of a statutory structure that permits that to be available for all taxpayers.

Q. Even with an income concept, you do admit there are component parts of an income tax base; isn't that correct?

A. Well, income is made up of a lot of additions or subtractions. It sets each item in the accounts as a component.

Q. So value added is made up of component parts, income is made up of component parts?

A. Right.

Q. So I suppose we could determine the income components from Caterpillar in Michigan by taking its Michigan sales and subtracting its Michigan expenses?

A. It's not quite as simply as that, because you have to look at a composite of internal transactions within Caterpillar to see which parts of its expenses are properly attributable to the sales in Michigan. You don't look just at the expenses in Michigan. You look at the expenses that belong to the receipts in Michigan. So —

Q. Isn't that somewhat inconsistent, though? You say on value added you just want to look at the Michigan components, but then on income you don't want to look at just the Michigan expenses?

A. You are not dealing with expenses in value added. You are looking at the value added as the base and it can only be added in one place. It's either in Michigan or out of Michigan. It can't be in both. And if the work is done out of Michigan, it's out-of-state compensation. The fact that that expense is part of a computation for income is a different question, and the income component is another question, and how you divide up the income component is the complex question. But it's not an important question, really, in this case, because we are not dealing with much income.

Q. Well, they had 93 million dollars of sales in Michigan.

A. Right. But there were 93 million dollars of sales as part of an overall activity which was conducted at a loss.

Q. But very little.

A. Except in one year, as I recall.

Q. And I think very little expenses in Michigan. Wouldn't that indicate that their Michigan activities are generating a lot of income?

A. That's not – it does not take into account the cost of the goods sold that are sold in Michigan, and the costs of the goods sold incurred outside of Michigan where the goods are produced. And so that if you are looking at the income element, you have to look at the income in terms of the income components of value added. And to do that you have to look at the company's entire accounts. If you are going to use the apportionment approach, if you want to use geographical separate accounting for income, then you have to reconstruct all of Caterpillar's accounts on a state-by-state basis.

Q. That seems somewhat inconsistent when you're saying our Legislature can't look at this value added concept as one ball of wax, you have to break it up into component parts. But now you are saying we can't break up the income on just Michigan receipts and Michigan expenses. We have to look at some place else.

A. You have to look at all of the components of the income. If you're taxing income, then you have to allow for multi-state taxpayers, the same definition of income as you are going to use for instate taxpayers and that will require the deduction of cost of goods sold.

Q. Professor Oldman, have you reviewed the returns filed by Caterpillar?

A. I have only looked at one of the Michigan value added tax returns, I have looked at one page.

Q. Have you looked at the apportionment formula?

A. I don't recall whether that was on that page or the next page or not. Presumably it was there. I only looked at that rapidly.

Q. Did you have any reason to believe that the property factor – would you believe that the property factor accurately reflects that extent of property in Michigan?

A. I have no reason to doubt it.

Q. And that the payroll factor accurately reflects the extent of payroll in Michigan?

A. Yes.

Q. And sales factor accurately reflects the extent of sales in Michigan?

A. Yes.

Q. So you have no problem with –

A. With those numbers?

Q. – with those numbers?

A. The problem is the use to which the sales factor number is put.

Q. Mr. Oldman, in your opinion, since Caterpillar has had no income and has losses, which you say should be apportioned, then you want to separately account for its payroll, which may well end up for a loss in this case, when we have so little Michigan payroll. So I think there is – do you understand my question? You have a large –

A. I think I understand. You would apportion losses just as you would apportion income.

Q. Right. And then apportioned that loss is greater than the Michigan compensation. So you end up with no tax base.

A. Because of the use of the sales factor, you might get yourself into the strange position of apportioning a loss to Michigan, which is greater than the amount of its actual payroll. And if you had carryovers of tax base allowed under the value added tax, then Caterpillar should be applying for a refund. Without carrying over each year. you can't have any less than zero tax base, so you don't have that problem.

Q. So we have a possibility of a negative tax base and the taxes imposed on the privilege of doing business. The taxpayers and Caterpillar have 60 to 90 million dollars sales in Michigan. So under your opinion, Caterpillar would pay no tax for the privilege of doing business?

A. It would happen in that situation. And that's the way the tax is basically designed, that if the net result of a given company's activity is not to have value added, but to actually consume value during the year. Now, it could be for the purpose of developing its future, maintaining relations with customers. It had a bad year, those things happen with companies, and therefore in that year, its tax base is so low that there is no tax at all that's due. There is no provision, as I understand in the Michigan VAT, SBT, for offsetting what would be a negative tax base in a given year, and it could arise with respect to multi-state taxpayers because of the way your factors are. It's something like the situation that I described earlier, when I said that some of the 7,000 taxpayers who don't sell in Michigan might end up with a tax that's much lower.

In some cases it might turn out that even if they sell in Michigan, the tax might be much lower because they had a loss instead of a profit, and for taxpayer who have losses nationwide, then the sales factor reduces that Michigan tax liability because they are now apportioning more of the loss, in a sense, to Michigan.

Q. I think we had one question, the excess compensation deduction. You testified that it was put in at the request of Michigan businesses that saw they had too much labor and would be wanting a break. Now, wouldn't that deduction also apply to multi-state taxpayers, to taxpayers like Caterpillar, as well?

A. So far as I know that works both ways, yes.

MR. GOMOLL: I have no further questions.

MR. HARNCK: I have no redirect.

THE COURT: You are excused. Your next witness?